

State Auto Financial CORP  
Form 10-Q  
November 04, 2009  
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 September 30, 2009

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 October 30, 2009, the Registrant had 39,771,541 Common Shares outstanding.

**Table of Contents**

**Index to Form 10-Q Quarterly Report for the three and nine month periods ended September 30, 2009**

**Part I. Financial Information**

Item 1.	Financial Statements (Unaudited)	
	<u>Condensed consolidated balance sheets – September 30, 2009 and December 31, 2008</u>	1
	<u>Condensed consolidated statements of income – Three months ended September 30, 2009 and 2008</u>	2
	<u>Condensed consolidated statements of income – Nine months ended September 30, 2009 and 2008</u>	3
	<u>Condensed consolidated statements of cash flows – Nine months ended September 30, 2009 and 2008</u>	4
	<u>Notes to condensed consolidated financial statements – September 30, 2009</u>	5
Item 2.	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	20
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	43
Item 4.	<u>Controls and Procedures</u>	43

**Part II. Other Information**

Item 1.	<u>Legal Proceedings</u>	44
Item 1A.	<u>Risk Factors</u>	44
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	44
Item 3.	<u>Defaults upon Senior Securities</u>	44
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	44
Item 5.	<u>Other Information</u>	44
Item 6.	<u>Exhibits</u>	46
	<u>Signatures</u>	47

**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>September 30 2009</b>	December 31 2008
	(unaudited)	(see Note 1)
<b>Assets</b>		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,775.9 and \$1,781.1, respectively)	\$ 1,844.0	1,770.7
Equity securities, available-for-sale, at fair value (cost \$153.7 and \$144.3, respectively)	175.3	137.5
Other invested assets, available-for-sale, at fair value (cost \$34.2 and \$32.4, respectively)	41.2	31.7
Notes receivable from affiliate	70.0	
Other invested assets	1.6	1.4
<i>Total investments</i>	2,132.1	1,941.3
Cash and cash equivalents	102.1	150.5
Accrued investment income and other assets	45.2	40.2
Deferred policy acquisition costs	130.7	122.3
Reinsurance recoverable on losses and loss expenses payable (affiliates \$0.2 and \$0.6, respectively)	24.9	21.2
Prepaid reinsurance premiums	7.4	7.0
Due from affiliate	9.6	
Current federal income taxes	43.2	37.6
Deferred federal income taxes	71.9	111.0
Property and equipment, at cost (net of accumulated depreciation of \$6.6 and \$6.2, respectively)	12.2	12.5
<i>Total assets</i>	\$ 2,579.3	2,443.6
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities:</b>		
Losses and loss expenses payable (affiliates \$355.6 and \$343.0, respectively)	\$ 839.9	791.2
Unearned premiums (affiliates \$184.3 and \$175.0, respectively)	558.0	515.1
Notes payable (affiliates \$15.5 and \$15.5, respectively)	117.3	117.6
Postretirement and pension benefits	164.5	187.7
Other liabilities	65.3	55.1
Due to affiliate		15.9
<i>Total liabilities</i>	1,745.0	1,682.6
Stockholders equity:		

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

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

Common stock, without par value. Authorized 100.0 shares; 46.5 and 46.3 shares issued, respectively, at stated value of \$2.50 per share

	<b>116.3</b>	115.9
Treasury stock, 6.8 shares, at cost	<b>(115.7)</b>	(115.5)
Additional paid-in capital	<b>113.9</b>	109.0
Accumulated other comprehensive loss	<b>(7.4)</b>	(97.6)
Retained earnings	<b>727.2</b>	749.2

<i>Total stockholders equity</i>	<b>834.3</b>	761.0
----------------------------------	--------------	-------

<i>Total liabilities and stockholders equity</i>	<b>\$ 2,579.3</b>	2,443.6
--------------------------------------------------	-------------------	---------

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 September 30	
	2009	2008
<b>Revenues</b>		
Earned premiums (ceded to affiliates \$188.8 and \$175.4, respectively)	\$ 298.3	280.7
Net investment income (affiliates \$1.2 in 2009)	21.6	23.0
Net realized gain (loss) on investments	3.6	(4.3)
Other income (affiliates \$0.5 and \$0.8, respectively)	1.0	1.2
<b>Total revenues</b>	<b>324.5</b>	300.6
<b>Expenses</b>		
Losses and loss expenses (ceded to affiliates \$126.3 and \$126.7, respectively)	203.8	231.2
Acquisition and operating expenses	102.0	94.9
Interest expense (affiliates \$0.2 and \$0.3, respectively)	1.8	1.8
Other expenses, net	3.2	2.9
<b>Total expenses</b>	<b>310.8</b>	330.8
<b>Income (loss) before federal income tax expense (benefit)</b>	<b>13.7</b>	(30.2)
Federal income tax expense (benefit)	0.7	(15.5)
<b>Net income (loss)</b>	<b>\$ 13.0</b>	(14.7)
Earnings (loss) per common share:		
Basic	\$ 0.33	(0.37)
Diluted	\$ 0.33	(0.37)
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)

**Condensed Consolidated Statements of Income**

(\$ millions, except per share amounts)

(unaudited)	Nine months ended September 30	
	2009	2008
<b>Revenues</b>		
Earned premiums (ceded to affiliates \$552.9 and \$522.2, respectively)	\$ 876.9	841.0
Net investment income (affiliates \$1.9 in 2009)	60.7	67.7
Net realized loss on investments	(5.2)	(3.7)
Other income (affiliates \$1.7 and \$2.4, respectively)	3.0	3.6
<b>Total revenues</b>	<b>935.4</b>	908.6
<b>Expenses</b>		
Losses and loss expenses (ceded to affiliates \$416.1 and \$421.4, respectively)	654.1	681.9
Acquisition and operating expenses	295.4	280.9
Interest expense (affiliates \$0.6 and \$0.9, respectively)	5.6	5.5
Other expenses, net	9.2	9.7
<b>Total expenses</b>	<b>964.3</b>	978.0
<b>Loss before federal income tax benefit</b>	<b>(28.9)</b>	(69.4)
Federal income tax benefit	(24.7)	(38.9)
<b>Net loss</b>	<b>\$ (4.2)</b>	(30.5)
Loss per common share:		
Basic	\$ (0.11)	(0.77)
Diluted	\$ (0.11)	(0.77)
Dividends paid per common share	\$ 0.45	0.45

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 Cash Flows**

<i>(\$ millions)</i>	Nine months ended	
(unaudited)	September 30	
	2009	2008
<b>Cash flows from operating activities:</b>		
Net loss	\$ (4.2)	(30.5)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization, net	9.4	6.4
Share-based compensation	2.9	4.8
Net realized loss on investments	5.2	3.7
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(8.3)	(7.2)
Accrued investment income and other assets	(0.1)	(2.0)
Postretirement and pension benefit	(2.1)	4.0
Other liabilities and due to/from affiliates, net	(25.1)	(2.8)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	(4.1)	(19.0)
Losses and loss expenses payable	48.7	136.2
Unearned premiums	42.9	30.5
Excess tax benefits on share based awards		0.4
Federal income taxes	(11.8)	(59.0)
Cash provided from Pooling Arrangement Amendment effective January 1, 2008		92.0
<b>Net cash provided by operating activities</b>	<b>53.4</b>	<b>157.5</b>
<b>Cash flows from investing activities:</b>		
Purchases of fixed maturities available-for-sale	(368.8)	(253.9)
Purchases of equity securities available-for-sale	(44.5)	(27.2)
Purchases of other invested assets	(2.9)	(24.7)
Maturities, calls and pay downs of fixed maturities available-for-sale	94.5	41.3
Sales of fixed maturities available-for-sale	278.2	119.3
Sales of equity securities available-for-sale	27.1	53.0
Sales of other invested assets	0.7	0.9
Notes to affiliate	(70.0)	
Net additions of property and equipment	(0.1)	(0.4)
<b>Net cash used in investing activities</b>	<b>(85.8)</b>	<b>(91.7)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	1.8	3.1
Payments to acquire treasury shares		(33.2)
Excess tax benefits on share based awards		0.4
Payment of dividends	(17.8)	(17.9)



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

<i>Net cash used in financing activities</i>	<b>(16.0)</b>	(47.6)
Net (decrease) increase in cash and cash equivalents	<b>(48.4)</b>	18.2
Cash and cash equivalents at beginning of period	<b>150.5</b>	70.9
<b>Cash and cash equivalents at end of period</b>	<b>\$ 102.1</b>	89.1
<u>Supplemental disclosures:</u>		
Federal income taxes (received) paid	<b>\$ (12.9)</b>	18.0
Interest paid (to affiliates \$0.7 and \$0.9, respectively)	<b>\$ 3.8</b>	4.1

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 (Unaudited)

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation ( 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 for complete financial statements. In the opinion of the Company s management, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine month period ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. The balance sheet at December 31, 2008 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required 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, 2008 (the 2008 Form 10-K ). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2008 Form 10-K.

*Adoption of Recent Accounting Pronouncements*

*Accounting Standards Codification*

In June 2009, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162* ( the Codification ). The Codification reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private sector standard setters into a single source of authoritative accounting principles arranged by topic. The Codification supersedes all existing U.S. accounting standards; all other accounting literature not included in the Codification (other than Securities and Exchange Commission guidance for publicly-traded companies) is considered non-authoritative. The Codification was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. The adoption of the Codification changed the Company s references to U.S. GAAP accounting standards but did not impact the Company s consolidated financial statements.

*Subsequent Events*

In May 2009, the FASB issued new guidance for accounting for subsequent events. The new guidance, which is now part of the FASB Accounting Standards Codification ( ASC ) Topic Subsequent Events, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, the new guidance sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements. The new guidance was effective on a prospective basis for interim or annual periods ending after June 15, 2009. The Company adopted this new guidance effective June 30, 2009, and determined it had no effect on the Company s consolidated financial statements. The disclosures required by this new guidance are provided in Note 14.

*Other-Than-Temporary Impairments*

In April 2009, the FASB issued new guidance for the accounting for other-than-temporary impairments. Under the new guidance, which is now part of the ASC Topic Investments Debt and Equity Securities, the indicators used in considering an impairment of a debt security to be other-than-temporary have been modified, from management asserting it has both the intent and the ability to hold an impaired security for a period of time sufficient for anticipated recovery in fair value to management asserting that (a) it does not have the intent to sell the security and

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

(b) it is more likely than not it will not have to sell the security before recovery. Additionally, this new guidance requires that other-than-temporary impairments on debt securities due to credit be recognized in earnings while non-credit other-than-temporary impairments be recognized in other comprehensive income. This new guidance also requires companies to disclose major security types for both debt and equity securities and to provide meaningful disclosure about individually significant unrealized losses and all such disclosures are required to be included in both interim and annual periods. This new guidance was effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted this new guidance effective April 1, 2009, and determined it did not have a material effect on the Company's consolidated financial statements. The disclosures required by this new guidance are provided in Note 2.

**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)

*Additional Fair Value Measurement Guidance*

In April 2009, the FASB issued new guidance for determining when a transaction is not orderly and for estimating fair value when there has been a significant decrease in the volume and level of activity for an asset or liability. The new guidance, which is now part of the ASC Topic Fair Value Measurements and Disclosures, requires disclosure of the inputs and valuation techniques used, as well as any changes in valuation techniques and inputs used during the period, to measure fair value in interim and annual periods. In addition, the presentation of the fair value hierarchy is required to be presented by major security type as described in the ASC Topic Investments – Debt and Equity Securities. The provisions of the new guidance were effective for interim periods ending after June 15, 2009. The Company adopted this new guidance effective April 1, 2009, and determined it did not have a material effect on the Company's consolidated financial statements. The disclosures required by this new guidance are provided in Note 3.

*Disclosures about Fair Value of Financial Instruments*

In April 2009, the FASB issued new guidance related to the disclosure of the fair value of financial instruments. The new guidance, which is now part of the ASC Topic Financial Instruments, requires disclosure of the fair value of financial instruments whether recognized or not recognized on the balance sheet in interim and annual financial statements. The provisions of the new guidance were effective for interim periods ending after June 15, 2009. The Company adopted this new guidance effective April 1, 2009. The disclosures required by this new guidance are provided in Notes 5 and 6.

*Pending Adoption of Accounting Pronouncements*

*Amendments to Accounting for Variable Interest Entities*

In June 2009, the FASB issued revised guidance on the accounting for variable interest entities. The revised guidance, which was issued as Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)*, has not yet been adopted into the Codification. The revised guidance reflects the elimination of the concept of a qualifying special-purpose entity and replaces the quantitative-based risks and rewards calculation of the previous guidance for determining which company, if any, has a controlling financial interest in a variable interest entity. The revised guidance requires an analysis of whether a company has: (1) the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (2) the obligation to absorb the losses that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity. An entity is required to be re-evaluated as a variable interest entity when the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights to direct the activities that most significantly impact the entity's economic performance. Additional disclosures are required about a company's involvement in variable interest entities and an ongoing assessment of whether a company is the primary beneficiary. The new guidance is effective on a prospective basis at the start of the Company's first fiscal year beginning after November 15, 2009. The Company is still assessing the impact the provisions of the new guidance will have on its consolidated financial statements.

*Employers' Disclosures about Postretirement Benefit Plan Assets*

In December 2008, the FASB issued new guidance on the disclosure of postretirement benefit plan assets. The new guidance, which is now part of the ASC Topic Compensation – Retirement Benefits, requires an employer to provide certain disclosures about plan assets of its defined benefit pension or other postretirement plans. The required disclosures include the investment policies and strategies of the plans, the fair value of the major categories of plan assets, the inputs and valuation techniques used to develop fair value measurements and a description of significant concentrations of risk in plan assets. The new guidance is effective on a prospective basis for fiscal years ending after December 15,

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

2009. The Company does not expect that the provisions of the new guidance will have a material effect 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 table summarizes the cost or amortized cost and fair value of available-for-sale securities at September 30, 2009:

(\$ millions)

	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	\$ 261.3	\$ 5.3	\$ (0.3)	\$ 266.3
Obligations of states and political subdivisions	1,129.5	51.0	(0.5)	1,180.0
Corporate securities	94.3	3.2		97.5
U.S. government agencies residential mortgage-backed securities	290.8	9.8	(0.4)	300.2
<i>Total fixed maturities</i>	1,775.9	69.3	(1.2)	1,844.0
<b>Equity securities:</b>				
<b>Large-cap equity securities:</b>				
Consumer	40.5	7.2	(0.4)	47.3
Technological	36.7	6.4	(0.8)	42.3
Industrial and materials	35.9	5.5	(0.7)	40.7
Energy	17.2	1.3	(1.2)	17.3
Financial services	7.7	2.7		10.4
Utilities	2.2			2.2
<i>Total large-cap equity securities</i>	140.2	23.1	(3.1)	160.2
Small-cap equity securities	13.5	1.6		15.1
<i>Total equity securities</i>	153.7	24.7	(3.1)	175.3
Other invested assets	34.2	7.0		41.2
<i>Total available-for-sale securities</i>	\$ 1,963.8	\$ 101.0	\$ (4.3)	\$ 2,060.5

**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)

At September 30, 2009, there were no individual investments reflected in the table below with an unrealized holding loss that had a fair value significantly below cost continually for more than one year. There were no individual securities with a material unrealized holding loss at September 30, 2009. The following table reflects the Company's gross unrealized losses and fair value on its investments, aggregated by investment category and length of time for individual securities, that have been in a continuous unrealized loss position at September 30, 2009:

Description of securities	Less than 12 months			12 months or more			Total		Number of positions
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	
<i>(\$ millions, except # of positions)</i>									
<b>Fixed maturities:</b>									
U.S. treasury securities and obligations of U.S. government agencies	\$ 25.0	\$	8	\$ 26.3	\$ (0.3)	3	\$ 51.3	\$ (0.3)	11
Obligations of states and political subdivisions	8.9	(0.1)	3	29.8	(0.4)	11	38.7	(0.5)	14
Corporate securities	3.2		2	1.0		1	4.2		3
U.S. government agencies residential mortgage-backed securities	1.2		1	22.0	(0.4)	11	23.2	(0.4)	12
<b>Total fixed maturities</b>	<b>38.3</b>	<b>(0.1)</b>	<b>14</b>	<b>79.1</b>	<b>(1.1)</b>	<b>26</b>	<b>117.4</b>	<b>(1.2)</b>	<b>40</b>
<b>Equity securities:</b>									
Consumer	7.1	(0.4)	3	2.4		1	9.5	(0.4)	4
Technological	5.8	(0.4)	2	7.3	(0.4)	2	13.1	(0.8)	4
Industrial and materials	6.2	(0.5)	1	2.9	(0.2)	2	9.1	(0.7)	3
Energy	1.7		1	8.5	(1.2)	2	10.2	(1.2)	3
Financial services	1.1		1				1.1		1
Utilities	2.2		2				2.2		2
<b>Total equity securities</b>	<b>24.1</b>	<b>(1.3)</b>	<b>10</b>	<b>21.1</b>	<b>(1.8)</b>	<b>7</b>	<b>45.2</b>	<b>(3.1)</b>	<b>17</b>
<b>Total temporarily impaired securities</b>	<b>\$ 62.4</b>	<b>\$ (1.4)</b>	<b>24</b>	<b>\$ 100.2</b>	<b>\$ (2.9)</b>	<b>33</b>	<b>\$ 162.6</b>	<b>\$ (4.3)</b>	<b>57</b>

The amortized cost and fair value of fixed maturities at September 30, 2009, by contractual maturity, are as follows:

*(\$ millions)*

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

	Amortized cost	Fair value
Due in 1 year or less	\$	
Due after 1 year through 5 years	141.4	145.8
Due after 5 years through 10 years	527.6	549.9
Due after 10 years	816.1	848.1
U.S. government agencies residential mortgage-backed securities	290.8	300.2
 <i>Total</i>	 \$1,775.9	 1,844.0

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 approximately \$54.1 million were on deposit with insurance regulators as required by law at September 30, 2009.



**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)

Components of net investment income for the three and nine months ended September 30 are summarized as follows:

(\$ millions)	Three months ended		Nine months ended	
	September 30		September 30	
	2009	2008	2009	2008
Fixed maturities	\$ 19.8	21.5	\$ 56.4	61.3
Equity securities	0.8	1.1	2.5	3.6
Cash and cash equivalents, and other	1.4	1.0	3.3	4.5
<i>Investment income</i>	22.0	23.6	62.2	69.4
<i>Investment expenses</i>	0.4	0.6	1.5	1.7
<i>Net investment income</i>	\$ 21.6	23.0	\$ 60.7	67.7

The Company's current investment strategy does not rely on the use of derivative financial instruments. See Note 3 for additional fair value disclosures.

Realized losses recognized for the three and nine months ended September 30 related to other-than-temporary impairments on the Company's investment portfolio are summarized as follows:

(\$ millions)	Three months ended		Nine months ended	
	September 30		September 30	
	2009	2008	2009	2008
Equity securities	\$ (0.9)	(5.9)	\$ (7.9)	(9.6)
<i>Total other-than-temporary impairments</i>	\$ (0.9)	(5.9)	\$ (7.9)	(9.6)

The Company considers the following factors when assessing its equity securities and other invested assets for other-than-temporary impairment: (1) the length of time and/or the significance of decline below cost; (2) its ability and intent to hold these securities through their recovery periods; (3) the current financial condition of the issuer and its future business prospects; and (4) the ability of the market value to recover to cost in the near term. The Company reviewed its investments at September 30, 2009, and determined no additional other-than-temporary impairment exists in the gross unrealized holding losses. The Company considers the following factors when assessing its fixed maturities investments for other-than-temporary impairment: (1) the financial condition of the issuer; (2) intent to sell; and (3) if it is more likely than not that the Company will be required to sell the investments before recovery. The Company did not recognize other-than-temporary impairments on its fixed maturity securities for the three and nine months ended September 30, 2009 and 2008.

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

Proceeds on sales of available-for-sale securities for the three and nine months ended September 30, 2009, were \$105.9 million and \$310.7 million, respectively.

The unrealized holding gains and losses, net of applicable deferred taxes, are shown as a separate component of stockholders' equity as a part of accumulated other comprehensive loss and, as such, are not included in the determination of net income (loss). Realized gains and losses on the sales of investments are computed using the first-in, first-out method.

**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)

Realized and unrealized holding gains and losses for the three and nine months ended September 30 are summarized as follows:

(\$ millions)	Three months ended September 30		Nine months ended September 30	
	2009	2008	2009	2008
<b>Realized gains:</b>				
Fixed maturities	\$ 2.0	0.8	\$ 5.2	1.5
Equity securities	2.7	1.5	4.0	8.7
<i>Total realized gains</i>	<b>4.7</b>	2.3	<b>9.2</b>	10.2
<b>Realized losses:</b>				
Fixed maturities			(0.1)	
Equity securities	(1.1)	(6.6)	(14.3)	(13.9)
<i>Total realized losses</i>	<b>(1.1)</b>	(6.6)	<b>(14.4)</b>	(13.9)
<i>Net realized gain (loss) on investments</i>	<b>\$ 3.6</b>	(4.3)	<b>\$ (5.2)</b>	(3.7)
<b>Change in unrealized holding gains (losses):</b>				
Fixed maturities	\$ 47.9	(53.9)	\$ 78.5	(78.6)
Equity securities	17.0	(1.7)	28.4	(31.4)
Other invested assets	5.8	(5.3)	7.7	(8.1)
Deferred federal income tax (liability) asset thereon	(24.7)	21.3	(40.1)	41.3
Valuation allowance			2.6	
<i>Change in net unrealized holding gains (losses)</i>	<b>\$ 46.0</b>	(39.6)	<b>\$ 77.1</b>	(76.8)

There was a deferred federal tax liability on the net unrealized holding gains at September 30, 2009, of \$33.8 million. There was a deferred federal tax asset on the net unrealized holding losses at December 31, 2008, of \$3.7 million, net of a valuation allowance of \$2.6 million.

**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.

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

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 a reasonable estimate. At September 30, 2009 the Company did not adjust any of the prices received from the pricing service.

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 pricing service to estimate fair value measurements for approximately 99.9% 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. 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. At September 30, 2009, the pricing service provided all valuations for the fixed maturity securities, except for one fixed maturity security discussed below.

**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 Company holds one fixed maturity 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 this security in Level 3.

*Equities*

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

*Other Invested Assets*

The fair value of other invested assets managed by third party investment managers consisting of two international funds ( the funds ) are based on the net asset value obtained from third party trustee statements. The net asset value reflects the fair value of the funds underlying investments, the majority of which have observable market quotes. 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. However, there are other inputs which are considered to be unobservable, and therefore the funds are classified as Level 3.

The remainder of the Company s other invested assets consist primarily of holdings in publicly-traded mutual funds. The Company believes that its estimates for these publicly-traded mutual funds reasonably reflect their fair values and consequently these securities have been disclosed in Level 1.

The table below summarizes the Company s available-for-sale investments within the fair value hierarchy at September 30, 2009:

<i>(\$ millions)</i>	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>Fixed maturities:</b>				
U.S. treasury securities and obligations of U.S. government agencies	\$ 266.3		266.3	
Obligations of states and political subdivisions	1,180.0		1,180.0	
Corporate securities	97.5		95.1	2.4
U.S. government agencies residential mortgage-backed securities	300.2		300.2	
<i>Total fixed maturities</i>	1,844.0		1,841.6	2.4
<b>Equity securities:</b>				
Large-cap equity securities:				
Consumer	47.3	47.3		

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

Technological	42.3	42.3		
Industrial and materials	40.7	40.7		
Energy	17.3	17.3		
Financial services	10.4	10.4		
Utilities	2.2	2.2		
<i>Total large-cap equity securities</i>	160.2	160.2		
Small-cap equity securities	15.1	15.1		
<i>Total equity securities</i>	175.3	175.3		
Other invested assets	41.2	3.9		37.3
<i>Total available-for-sale investments</i>	\$ 2,060.5	179.2	1,841.6	39.7

**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), a reconciliation of the beginning and ending balances, separately for each major category of assets, is as follows:

Fair value measurements using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2009:

(\$ millions)

	Fixed maturities	Other invested assets
Balance at January 1, 2009	\$ 2.3	28.8
Total realized gains and losses		(4.6)
Included in other comprehensive loss total gains or losses unrealized	0.2	0.2
Purchases, issuances, and settlements		
Transfers in and/or out of Level 3		
Balance at March 31, 2009	2.5	24.4
Total realized gains and losses		5.4
Included in other comprehensive loss total gains or losses unrealized	(0.1)	0.4
Purchases, issuances, and settlements		
Transfers in and/or out of Level 3		
Balance at June 30, 2009	2.4	30.2
Total realized gains and losses		4.9
Included in other comprehensive loss total gains or losses unrealized		0.3
Purchases, issuances, and settlements		1.9
Transfers in and/or out of Level 3		
Balance at September 30, 2009	\$ 2.4	37.3

Fair value measurements using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2008:

(\$ millions)

	Fixed maturities	Other invested assets
Balance at January 1, 2008	\$ 2.1	16.3
Total realized gains and losses		
Included in other comprehensive loss total gains or losses unrealized		(0.9)
Purchases, issuances, and settlements		8.0
Transfers in and/or out of Level 3		

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

Balance at March 31, 2008	2.1	23.4
Total realized gains and losses		
Included in other comprehensive loss total gains or losses unrealized		(1.7)
Purchases, issuances, and settlements		8.0
Transfers in and/or out of Level 3		
Balance at June 30, 2008	2.1	29.7
Total realized gains and losses		
Included in other comprehensive loss total gains or losses unrealized	0.1	(4.9)
Purchases, issuances, and settlements		8.0
Transfers in and/or out of Level 3		
Balance at September 30, 2008	\$ 2.2	32.8



**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)

Below is a summary of the carrying value and fair value of financial instruments at September 30, 2009:

<i>(\$ millions)</i>	Carrying value	Fair value	Reference
<b>Assets:</b>			
Fixed maturities, available-for-sale, at fair value	\$ 1,844.0	\$ 1,844.0	See above
Equity securities, available-for-sale, at fair value	175.3	175.3	See above
Other invested assets, available-for-sale, at fair value	41.2	41.2	See above
Notes receivable from affiliate	70.0	70.7	See Note 5
<b>Liabilities:</b>			
Notes payable	117.3	116.7	See Note 6

**4. Reinsurance**

A quota share reinsurance pooling arrangement (the *Pooling Arrangement*) exists between State Auto Property & Casualty Insurance Company, Milbank Insurance Company, Farmers Casualty Insurance Company, and State Auto Insurance Company of Ohio, (collectively referred to as the *STFC Pooled Companies*) and 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 (*Meridian Security*), Beacon National Insurance Company, Patrons Mutual Insurance Company of Connecticut, and Litchfield Mutual Fire Insurance Company (collectively referred to as the *Mutual Pooled Companies*). Together, the *STFC Pooled Companies* and *Mutual Pooled Companies* are collectively referred to as the *Pooled Companies* or the *State Auto Pool*.

The following table provides a summary of the Company's reinsurance transactions with other insurers and reinsurers, as well as reinsurance transactions with affiliates:

<i>(\$ millions)</i>	Three months ended September 30		Nine months ended September 30	
	2009	2008	2009	2008
<b>Premiums earned</b>				
Assumed from other insurers and reinsurers	\$ 1.3	1.6	\$ 3.9	4.3
Assumed under State Auto Pool and other affiliate arrangements	288.8	270.1	847.3	808.7
Ceded to other insurers and reinsurers	(6.4)	(6.7)	(19.9)	(16.3)
Ceded under State Auto Pool and other affiliate arrangements	(188.8)	(175.4)	(552.9)	(522.2)
<b>Net assumed premiums earned</b>	<b>\$ 94.9</b>	89.6	<b>\$ 278.4</b>	274.5
<b>Losses and loss expenses incurred</b>				
Assumed from other insurers and reinsurers	\$ 1.1	0.6	\$ 2.0	1.9
Assumed under State Auto Pool and other affiliate arrangements	194.7	224.1	628.1	655.1

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

Ceded to other insurers and reinsurers	(4.5)	(18.5)	(13.5)	(20.1)
Ceded under State Auto Pool and other affiliate arrangements	(126.3)	(126.7)	(416.1)	(421.4)
<i>Net assumed losses and loss expenses incurred</i>	<b>\$ 65.0</b>	79.5	<b>\$ 200.5</b>	215.5

**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)

**5. Transactions with Affiliates**

In May 2009, State Auto Financial's subsidiaries State Auto P&C and Milbank entered into separate Credit Agreements with State Auto Mutual, in which they loaned State Auto Mutual \$70.0 million (\$50.0 million and \$20.0 million, respectively) for ten years. Interest is due semi-annually at a fixed annual interest rate of 7.00%, with the principal due May 2019. There is no prepayment penalty, and there was no collateral given in exchange for the notes.

Under this agreement, State Auto Financial earned interest of \$1.2 million and \$1.9 million for the three and nine months ended September 30, 2009. 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. Notes receivable at September 30, 2009, consisted of the following:

<i>(\$ millions, except interest rates)</i>	Carrying value	Fair value	Interest rate
Notes receivable from affiliate	\$ 70.0	\$ 70.7	7.00%

**6. Notes Payable**

The carrying amount of the Subordinated Debentures in the consolidated balance sheets approximates its fair value as the interest rate adjusts quarterly. The \$100.0 million, 6.25% Senior Notes have a fair value of \$101.2 million at September 30, 2009. The fair value of the Senior Notes is based on the quoted market price at September 30, 2009. Notes payable at September 30 consisted of the following:

<i>(\$ millions, except interest rates)</i>	Carrying value	Fair value	Interest rate
Senior Notes due 2013: issued \$100.0, November 2003 with fixed interest	\$ 101.8	\$ 101.2	6.25%
Affiliate subordinated debentures due 2033: issued \$15.5, May 2003 with variable interest	15.5	15.5	4.87%
<b>Total notes payable</b>	<b>\$ 117.3</b>	<b>\$ 116.7</b>	

State Auto Financial has a credit facility (the Credit Facility) with a syndicate of financial institutions. On April 1, 2009, the Credit Facility was amended as follows:

1. The maximum amount which may be borrowed by State Auto Financial was reduced from \$200.0 million to \$100.0 million;

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

2. The amount of loans that may be advanced from State Auto Financial and its subsidiaries to State Auto Mutual and its subsidiaries (that are not State Auto Financial or its subsidiaries) was increased from \$50.0 million to \$75.0 million;
3. The definition of net worth was modified to exclude accumulated other comprehensive income (loss); and
4. State Auto Financial's minimum net worth covenant was modified.

As amended, the Credit Facility provides for a \$100.0 million unsecured revolving credit facility maturing in July 2012. The Credit Facility is available for general corporate purposes. The Credit Facility provides for interest-only payments during its term, with principal due in full at maturity. Interest is based on a London interbank market rate or a base rate plus a calculated margin amount. The Credit Facility includes certain covenants, including financial covenants that require the Company to maintain a minimum net worth and not exceed a certain debt to capitalization ratio. As of September 30, 2009, the Company was in compliance with all covenants related to the Credit Facility. As of September 30, 2009, the Company had not made any borrowings under the Credit Facility.

### **7. Income Taxes**

The uncertainty of our expected 2009 full year results precludes us from making a reliable estimate of an expected full year tax rate. Accordingly, the Company recorded a tax benefit based on the results for the nine months ended September 30, 2009. The effective tax rate differs from the statutory rate of 35% principally because of tax exempt investment income. The effective tax rate for the three and nine months ended September 30, 2009 was 5.1% and 85.5%, 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)

**8. Restructuring Costs**

In June 2009, the Company initiated a plan to restructure its field and claims operations. Restructuring charges, including employee termination benefits, relocation packages, and costs associated with ceasing to use leased properties, related to this reorganization have been recognized in accordance with the Exit or Disposal Cost Obligations Topic of the FASB ASC. The Company recognized \$3.2 million and \$4.2 million, respectively, during the three and nine months ended September 30, 2009, and anticipates additional charges of approximately \$5.2 million through the fourth quarter 2010, the expected completion date. These charges are included in losses and loss expenses and acquisition and operating expenses on the condensed consolidated statements of income.

The Company's plan to restructure its field and claims operations is anticipated to eliminate expected years of future services of those impacted employees, resulting in a curtailment of the Company's pension and postretirement benefit plans. At June 30, 2009, after remeasurement and curtailment gain recognition, the pension and postretirement benefits obligations were reduced by \$4.3 million and \$8.8 million, respectively, and accumulated other comprehensive loss declined \$8.6 million, net of tax.

Total cumulative estimated costs to be incurred and costs incurred through September 30, 2009, at fair value are as follows:

<i>(\$ millions)</i>	Total cumulative estimated costs to be incurred	Costs incurred during the three months ended September 30, 2009	Costs incurred during the nine months ended September 30, 2009	Cumulative costs incurred through September 30, 2009
Employee termination benefits	\$ 6.5	2.5	3.2	3.2
Relocation costs	2.2	0.5	0.8	0.8
Lease termination	0.7	0.2	0.2	0.2
<i>Total</i>	\$ 9.4	3.2	4.2	4.2

These costs are allocated to the Company's insurance segments at fair value as follows:

<i>(\$ millions)</i>	Total cumulative estimated costs to be incurred	Costs incurred during the three months ended September 30, 2009	Costs incurred during the nine months ended September 30, 2009	Cumulative costs incurred through September 30, 2009
Personal insurance	\$ 4.2	1.8	2.3	2.3
Business insurance	5.2	1.4	1.9	1.9
<i>Total</i>	\$ 9.4	3.2	4.2	4.2

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

Activity for the nine months ended September 30, 2009, at fair value was as follows:

<i>(\$ millions)</i>	Balance of liability at December 31, 2008	Costs incurred during the nine months ended September 30, 2009	Amounts paid during the nine months ended September 30, 2009	Balance of liability at September 30, 2009
Employee termination benefits	\$	3.2	0.2	3.0
Relocation costs		0.8	0.8	
Lease termination		0.2		0.2
<i>Total</i>	\$	4.2	1.0	3.2

**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)

**9. Pension and Postretirement Benefit Plans**

The following table provides components of net periodic cost for the State Auto Group of Companies pension and postretirement benefit plans:

(\$ millions)	Pension		Postretirement		Pension		Postretirement	
	Three months ended				Nine months ended			
	September 30				September 30			
	2009	2008	2009	2008	2009	2008	2009	2008
Service cost	\$ 2.3	2.2	\$ 1.1	1.3	\$ 7.8	6.6	\$ 3.8	3.9
Interest cost	3.5	3.4	1.3	1.9	10.8	10.2	4.9	5.7
Expected return on plan assets	(4.2)	(4.8)			(14.1)	(14.4)	(0.1)	
Curtailed loss (gain)	0.3		(0.6)		0.3		(0.6)	
Amortization of:								
Prior service costs	0.1	0.1	(1.4)	0.1	0.3	0.3	(1.3)	0.3
Transition assets	(0.1)	(0.2)			(0.4)	(0.6)		
Net loss	1.2	0.7	0.1		3.8	2.1	0.3	
<i>Net periodic cost</i>	\$ 3.1	1.4	\$ 0.5	3.3	\$ 8.5	4.2	\$ 7.0	9.9

For the nine months ended September 30, 2009, the Company contributed \$15.0 million in cash to its pension plan.

As a result of the Company's restructuring (Note 8), the Company decreased accumulated other comprehensive loss by \$2.9 million and \$5.7 million, net of tax, for the Pension and Postretirement plans, respectively.

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

The following table sets forth the computation of basic and diluted earnings (loss) per common share:

(\$ millions, except per share amounts)	Three months ended		Nine months ended	
	September 30	2008	September 30	2008
	2009	2008	2009	2008
<b>Numerator:</b>				
Net income (loss) for basic earnings per share	\$ 13.0	(14.7)	\$ (4.2)	(30.5)
<b>Denominator:</b>				
Basic weighted average shares outstanding	39.7	39.5	39.7	39.7
Effect of dilutive share-based awards	0.2			

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

Diluted weighted average shares outstanding	<b>39.9</b>	39.5	<b>39.7</b>	39.7
Basic earnings (loss) per share	<b>\$ 0.33</b>	(0.37)	<b>\$ (0.11)</b>	(0.77)
Diluted earnings (loss) per share	<b>\$ 0.33</b>	(0.37)	<b>\$ (0.11)</b>	(0.77)



**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 number of options to purchase shares of common stock was not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price or their inclusion would have been antidilutive:

<i>(number of options in millions)</i>	Three months ended		Nine months ended	
	September 30 <b>2009</b>	2008	September 30 <b>2009</b>	2008
Number of options	<b>2.4</b>	1.4	<b>2.1</b>	1.4

**11. Comprehensive Income (Loss)**

The components of comprehensive income (loss), net of related tax, are as follows:

<i>(\$ millions)</i>	Three months ended		Nine months ended	
	September 30 <b>2009</b>	2008	September 30 <b>2009</b>	2008
Net income (loss)	<b>\$ 13.0</b>	(14.7)	<b>\$ (4.2)</b>	(30.5)
Other comprehensive income (loss):				
Change in unrealized holding gains (losses), net of tax	<b>46.0</b>	(39.6)	<b>77.1</b>	(76.8)
Amortization of gain on derivative used in cash flow hedge			<b>(0.1)</b>	
Change in unrecognized benefit plan obligations, net of tax	<b>(0.1)</b>	0.5	<b>13.2</b>	1.4
<i>Total other comprehensive income (loss)</i>	<b>45.9</b>	(39.1)	<b>90.2</b>	(75.4)
<i>Comprehensive income (loss)</i>	<b>\$ 32.9</b>	(53.8)	<b>\$ 86.0</b>	(105.9)

**12. Segment Information**

The Company has three significant reportable segments: personal insurance, business 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 operate in 33 states and distribute their products through our independent insurance agency system. The personal insurance segment provides primarily personal auto (standard and nonstandard) and homeowners to the personal insurance market. The business insurance segment provides primarily commercial auto, commercial multi-peril, fire and allied lines, other and product liability and workers' compensation insurance to small-to-medium sized businesses within the commercial insurance market. The Company's investable assets, the investment operations segment, are managed by Stateco Financial Services, Inc, a wholly owned subsidiary. The Company's investment portfolio is comprised primarily of publicly traded fixed income and equity securities.

The Company evaluates the performance of its insurance segments using industry financial measurements determined based on Statutory Accounting Principles (SAP), which include loss and loss adjustment expense ratios, underwriting expense ratios, combined ratios, statutory

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

underwriting gain (loss), net premiums earned and net premiums written. The most significant difference between SAP and Generally Accepted Accounting Principles ( GAAP ) is that SAP requires all underwriting expenses to be expensed immediately and not deferred 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 provides financial information regarding the Company's reportable segments:

<i>(\$ millions)</i>	Three months ended September 30		Nine months ended September 30	
	<b>2009</b>	2008	<b>2009</b>	2008
Revenues from external sources				
Insurance segments:				
Personal insurance	<b>\$ 186.9</b>	167.6	<b>\$ 541.2</b>	499.6
Business insurance	<b>111.4</b>	113.1	<b>335.7</b>	341.4
<i>Total insurance segments</i>	<b>298.3</b>	280.7	<b>876.9</b>	841.0
Investment operations segment:				
Net investment income	<b>21.6</b>	23.0	<b>60.7</b>	67.7
Net realized capital gains (losses)	<b>3.6</b>	(4.3)	<b>(5.2)</b>	(3.7)
<i>Total investment operations segment</i>	<b>25.2</b>	18.7	<b>55.5</b>	64.0
All other	<b>1.0</b>	1.2	<b>3.0</b>	3.6
<i>Total revenues from external sources</i>	<b>324.5</b>	300.6	<b>935.4</b>	908.6
Intersegment revenues	<b>(2.4)</b>	(2.4)	<b>(7.2)</b>	(7.3)
<i>Total revenues</i>	<b>322.1</b>	298.2	<b>928.2</b>	901.3
Reconciling items:				
Eliminate intersegment revenues	<b>2.4</b>	2.4	<b>7.2</b>	7.3
<i>Total consolidated revenues</i>	<b>\$ 324.5</b>	300.6	<b>\$ 935.4</b>	908.6
Segment income (loss) before federal income tax				
Insurance segments:				
Personal insurance SAP underwriting loss	<b>\$ (2.8)</b>	(31.6)	<b>\$ (55.9)</b>	(78.4)
Business insurance SAP underwriting loss	<b>(1.6)</b>	(14.3)	<b>(17.0)</b>	(53.3)
<i>Total insurance segments</i>	<b>(4.4)</b>	(45.9)	<b>(72.9)</b>	(131.7)
Investment operations segment:				
Net investment income	<b>21.6</b>	23.0	<b>60.7</b>	67.7
Net realized capital gains (losses)	<b>3.6</b>	(4.3)	<b>(5.2)</b>	(3.7)
<i>Total investment operations segment</i>	<b>25.2</b>	18.7	<b>55.5</b>	64.0
All other segments	<b>(0.2)</b>	(0.5)	<b>(0.8)</b>	(1.4)

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

<i>Total segment income (loss) before tax expense (benefit)</i>	<b>20.6</b>	(27.7)	<b>(18.2)</b>	(69.1)
Reconciling items:				
GAAP expense adjustments	<b>(4.5)</b>	(0.3)	<b>(3.7)</b>	7.1
Interest expense on corporate debt	<b>(1.8)</b>	(1.8)	<b>(5.6)</b>	(5.5)
Corporate expenses	<b>(0.6)</b>	(0.4)	<b>(1.4)</b>	(1.9)
<i>Total reconciling items</i>	<b>(6.9)</b>	(2.5)	<b>(10.7)</b>	(0.3)
<i>Total consolidated income (loss) before federal income tax expense (benefit)</i>	<b>\$ 13.7</b>	(30.2)	<b>\$ (28.9)</b>	(69.4)

**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)

Revenues from external sources for reportable segments include the following products and services:

(\$ millions)	Three months ended		Nine months ended	
	September 30 2009	2008	September 30 2009	2008
<b>Earned premiums:</b>				
Personal insurance:				
Standard personal auto	\$ 111.0	96.9	\$ 318.9	285.3
Nonstandard personal auto	9.5	10.7	29.6	32.3
Homeowners	58.5	53.0	169.7	160.8
Other personal	7.9	7.0	23.0	21.2
<b>Total personal insurance earned premiums</b>	<b>186.9</b>	167.6	<b>541.2</b>	499.6
Business insurance:				
Commercial auto	26.4	27.7	80.5	83.0
Commercial multi-peril	24.1	24.3	72.1	73.7
Fire & allied lines	24.8	23.0	72.8	70.6
Other & product liability	18.6	20.0	57.1	60.4
Workers compensation	10.9	11.1	33.2	32.2
Other business	6.6	7.0	20.0	21.5
<b>Total business insurance earned premiums</b>	<b>111.4</b>	113.1	<b>335.7</b>	341.4
<b>Total earned premiums</b>	<b>298.3</b>	280.7	<b>876.9</b>	841.0
Investment operations:				
Net investment income	21.6	23.0	60.7	67.7
Net realized capital gain (loss)	3.6	(4.3)	(5.2)	(3.7)
<b>Total investment operations</b>	<b>25.2</b>	18.7	<b>55.5</b>	64.0
<b>Total revenues from significant reportable segments</b>	<b>\$ 323.3</b>	299.4	<b>\$ 932.4</b>	905.0

Investable assets attributable to the Company's investment operations segment totaled \$2,234.2 million at September 30, 2009, and \$2,091.8 million at December 31, 2008.

**13. Contingencies and Litigation**

The Company's insurance subsidiaries are involved in a number of lawsuits, and may become involved in other potential litigation, arising in the ordinary course of business. Generally, the involvement of an insurance subsidiary in a lawsuit involves defending third-party claims brought against its insureds (in its role as liability insurer) or as a principal of surety bonds and defending policy coverage claims brought against the

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

insurance subsidiary. All lawsuits relating to such insurance claims are considered by the Company in establishing the Company's loss and loss adjustment expense reserves.

In accordance with the Contingencies Topic of the FASB ASC, the Company accrues for a litigation-related liability other than insurance claims when it is probable that such a liability has been incurred and the amount of the loss can be reasonably estimated. Based on currently available information known to the Company, the Company believes that its reserves for these litigation-related liabilities are reasonable and that the ultimate outcomes of any pending matters are not likely to have a material adverse effect on its consolidated financial position or results of operations.

Additionally, the insurance subsidiaries may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope originally contemplated in their 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 position or results from operations.

### **14. Subsequent Events**

The Company has evaluated events subsequent to the balance sheet date through November 4, 2009, which represents the filing date of this Form 10-Q.

---

**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 Operations**

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 "third quarter" as used below refers to the three months ended September 30. The term "SAP" as used below refers to Statutory Accounting Principles and the term "GAAP" as used below refers to U.S. Generally Accepted Accounting Principles.

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 September 30, 2009, and December 31, 2008, and for the consolidated statements of income for the three-month and nine-month periods ended September 30, 2009 and 2008. This discussion and analysis should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our Annual Report on Form 10-K for our year ended December 31, 2008 (the "2008 Form 10-K"), and in particular the discussions in those sections thereof entitled "Executive Summary" and "Critical Accounting Policies." Readers are encouraged to review the entire 2008 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 2008 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.

We have three significant reportable segments—personal insurance, business 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 operate in 33 states and distribute their products through the independent insurance agency system. The personal insurance segment provides primarily personal auto (standard and nonstandard) and homeowners insurance to the personal insurance market. The business insurance segment provides primarily commercial auto, commercial multi-peril, fire and allied lines, other and product liability and workers' compensation insurance to small-to-medium sized businesses within the commercial insurance market. Our investable assets, the investment operations segment, are managed by our subsidiary Stateco Financial Services, Inc ("Stateco"). Our investment portfolio is comprised primarily of publicly traded fixed income and equity securities. Financial information about our segments is set forth in Note 12 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

A quota share reinsurance pooling arrangement (the "Pooling Arrangement") exists between State Auto Property & Casualty Insurance Company ("State Auto P&C"), Milbank Insurance Company ("Milbank"), Farmers Casualty Insurance Company ("Farmers"), and State Auto Insurance Company of Ohio ("SA Ohio"), (collectively referred to as the "STFC Pooled Companies") and State Automobile Mutual Insurance Company ("State Auto Mutual") and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin ("SA Wisconsin"), State Auto Florida Insurance Company ("SA Florida"), Meridian Citizens Mutual Insurance Company ("Meridian Citizens Mutual"), Meridian Security Insurance Company ("Meridian Security"), Patrons Mutual Insurance Company of Connecticut ("Patrons Mutual"), and Litchfield Mutual Fire Insurance Company ("Litchfield") (collectively referred to as the "Patrons Insurance Group") and Beacon National Insurance Company ("Beacon National"), (collectively referred to as the "Mutual Pooled Companies"). Together, the STFC Pooled Companies and Mutual Pooled Companies are collectively referred to as the "Pooled Companies" or the "State Auto Pool." The State Auto Pool has an A.M. Best rating of A+ (Superior). See "Important Defined Terms Used" in the 2008 Form 10-K.

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

As of January 1, 2008, the Pooling Arrangement was amended to add Beacon National, Patrons Mutual and Litchfield as participants and the middle market business of State Auto Mutual and Meridian Security to the Pooling Arrangement (collectively, the Pooling Change ).

The Pooled Companies and State Auto National Insurance Company ( SA National ) are collectively referred to herein as the State Auto Group.



**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

During the third quarter 2009, the assets of our subsidiary Strategic Insurance Software, Inc., a developer and seller of insurance-related software, were sold to a third party. The assets and operations of this subsidiary were not, and the sale proceeds are not, material to our total operations.

**RESULTS OF OPERATIONS**

During our third quarter 2009, we recognized net income of \$13.0 million compared to a net loss of \$14.7 million for the same 2008 period. Income before federal income taxes for the three months ended September 30, 2009 was \$13.7 million compared to a pre-tax net loss of \$30.2 million for the same 2008 period. The improvement in our third quarter 2009 results was primarily attributable to a reduction in the severity of our catastrophe losses, as well as an increase in our earned premiums.

During the nine months ended September 30, 2009, we recognized a net loss of \$4.2 million compared to a net loss of \$30.5 million for the same 2008 period. Loss before federal income taxes for the nine months ended September 30, 2009 was \$28.9 million compared to \$69.4 million for the same 2008 period. The decrease in our pre-tax net loss for the first nine months of 2009 compared to the same period in 2008 was primarily attributable to an increase in our earned premiums, primarily in personal lines, as well as a reduction in the number and severity of our catastrophe losses.

The following table summarizes certain key performance metrics for the three and nine months ended September 30, 2009 and 2008 that we use to monitor our financial performance:

<i>(\$ millions, except per share amounts)</i>	Three months ended		Nine months ended	
	September 30		September 30	
	<b>2009</b>	2008	<b>2009</b>	2008
GAAP Basis:				
Total revenue	<b>\$ 324.5</b>	300.6	<b>\$ 935.4</b>	908.6
Net income (loss)	<b>\$ 13.0</b>	(14.7)	<b>\$ (4.2)</b>	(30.5)
Stockholders' equity	<b>\$ 834.3</b>	787.8		
Book value per share	<b>\$ 21.00</b>	19.94		
Debt to capital ratio	<b>12.3</b>	13.0		
Loss and LAE ratio <sup>(1)</sup>	<b>68.3%</b>	82.4	<b>74.6%</b>	81.1
Expense ratio <sup>(1)</sup>	<b>34.2%</b>	33.8	<b>33.7%</b>	33.4
Combined ratio <sup>(1)</sup>	<b>102.5%</b>	116.2	<b>108.3%</b>	114.5
Catastrophe loss and LAE points	<b>3.6</b>	19.5	<b>10.4</b>	19.8
Premium written growth <sup>(2)</sup>	<b>5.5%</b>	13.5	<b>5.7%</b>	18.8
Premium earned growth	<b>6.3%</b>	11.3	<b>4.3%</b>	11.1
Investment yield	<b>4.2%</b>	4.3	<b>3.9%</b>	4.2
SAP Basis :				
Loss and LAE ratio <sup>(3)</sup>	<b>67.4%</b>	82.0	<b>74.2%</b>	80.7
Expense ratio <sup>(3)</sup>	<b>32.3%</b>	32.4	<b>33.6%</b>	31.8
Combined ratio <sup>(3)</sup>	<b>99.7%</b>	114.4	<b>106.8%</b>	112.5

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

	Twelve months ended September 30	
	2009	2008
Net premiums written to surplus <sup>(4)</sup>	1.6	1.4

(1) Defined below in Insurance Segments.

(2) 6.9 points of the percentage increase for the nine months ended September 30, 2008, related to the one-time \$53.6 million transfer of unearned premium to us on January 1, 2008, in conjunction with the Pooling Change.

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

- (3) SAP Loss and LAE Ratio is losses and loss expenses as a percentage of net earned premium. SAP Expense Ratio is statutory underwriting expenses and miscellaneous expenses offset by miscellaneous income (underwriting expenses) as a percentage of net written premiums. SAP Combined Ratio is the sum of the SAP Loss and LAE Ratio and the SAP Expense Ratio.
- (4) We use the statutory net premiums written to surplus ratio as there is no comparable GAAP measure. This ratio, also called the leverage ratio, which measures a company's statutory surplus available to absorb losses.

---

***Insurance Segments***

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. The more common financial measures used are loss and LAE ratios, underwriting expense ratio, combined ratio, net premiums written and net premiums earned. The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio. When the combined ratio is less than 100%, the insurer is operating at an underwriting gain and when it is greater than 100%, the insurer is operating at an underwriting loss. Underwriting gain (loss) is determined by subtracting from net earned premiums, losses and loss expenses and underwriting expenses.

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 policy acquisition costs see Critical Accounting Policies Deferred Acquisition Costs included in Item 7 of our 2008 Form 10-K. The GAAP Combined Ratio is the sum of the GAAP Loss and LAE Ratio (loss and loss expenses as a percentage of earned premium) plus the GAAP Expense Ratio (acquisition and operating expenses as a percentage of earned premiums).

Charges related to the restructuring of our field and claims operations (discussed below) contribute to the difference between our GAAP Expense Ratio and our SAP Expense Ratio. These differences relate mainly to the timing of the recognition of employee termination benefits. SAP requires us to estimate and immediately recognize the entire estimated costs related to severance, while GAAP requires similar estimated costs to be recognized ratably over the remaining service period of the employees impacted.

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 provide a summary of our insurance segments' SAP underwriting loss and SAP Combined Ratio for the three and nine months ended September 30, 2009 and 2008:

(\$ millions)

	Three months ended September 30, 2009					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Net written premiums	\$ 207.3		\$ 107.0		\$ 314.3	
Net earned premiums	186.9		111.4		298.3	
Losses and loss expenses	128.1	68.5	73.1	65.6	201.2	67.4
Underwriting expenses	61.5	29.7	40.0	37.4	101.5	32.3
SAP underwriting loss and SAP Combined Ratio	\$ (2.8)	98.2	\$ (1.6)	103.0	\$ (4.4)	99.7

(\$ millions)

	Three months ended September 30, 2008					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Net written premiums	\$ 183.2		\$ 114.6		\$ 297.8	
Net earned premiums	167.6		113.1		280.7	
Losses and loss expenses	144.8	86.4	85.4	75.5	230.2	82.0
Underwriting expenses	54.4	29.7	42.1	36.7	96.5	32.4
SAP underwriting loss and SAP Combined Ratio	\$ (31.6)	116.1	\$ (14.4)	112.2	\$ (46.0)	114.4

(\$ millions)

	Nine months ended September 30, 2009					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Net written premiums	\$ 584.2		\$ 335.2		\$ 919.4	
Net earned premiums	541.2		335.7		876.9	
Losses and loss expenses	423.7	78.3	226.8	67.6	650.5	74.2
Underwriting expenses	173.4	29.7	125.9	37.5	299.3	32.6
SAP underwriting loss and SAP Combined Ratio	\$ (55.9)	108.0	\$ (17.0)	105.1	\$ (72.9)	106.8

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

(\$ millions)

	Nine months ended September 30, 2008					
	Personal	%	Business	%	Total	%
Net written premiums <sup>(1)</sup>	\$ 544.8		\$ 378.9		\$ 923.7	
Net earned premiums	499.6		341.4		841.0	
Losses and loss expenses	423.4	84.7	255.2	74.8	678.6	80.7
Underwriting expenses	154.6	28.4	139.5	36.8	294.1	31.8
SAP underwriting loss and SAP Combined Ratio	\$ (78.4)	113.1	\$ (53.3)	111.6	\$ (131.7)	112.5

<sup>(1)</sup> Includes the one-time transfer of \$53.6 million of unearned premiums to us on January 1, 2008, in conjunction with the Pooling Change (\$24.8 million for our personal insurance segment and \$28.8 million for our business insurance segment).

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

*Revenue*

We measure our 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 terms of the policy.

The following table shows the one-time impact on net written premiums for the nine months ended September 30, 2008, of the unearned premiums transferred to us on January 1, 2008, in conjunction with the Pooling Change.

(\$ millions)	Net Written Premiums Reconciliation Table		
	Including Pooling Change	Pooling Change Impact	Excluding Pooling Change
<b>Personal insurance segment:</b>			
Standard auto	\$ 305.7	\$ 7.9	\$ 297.8
Nonstandard auto	33.3		33.3
Homeowners	181.3	14.4	166.9
Other personal	24.5	2.5	22.0
<i>Total personal</i>	544.8	24.8	520.0
<b>Business insurance segment:</b>			
Commercial auto	92.9	10.0	82.9
Commercial multi-peril	82.3	6.1	76.2
Fire & allied lines	77.5	5.7	71.8
Product & other liability	65.9	3.9	62.0
Workers compensation	36.8	2.0	34.8
Other business	23.5	1.1	22.4
<i>Total business</i>	378.9	28.8	350.1
<i>Total personal &amp; business</i>	\$ 923.7	\$ 53.6	\$ 870.1

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

*Personal Insurance Segment Revenue*

Our personal insurance segment consists primarily of auto (standard and nonstandard) and homeowners products, with personal auto representing 40.8% of our total consolidated net written premiums.

The following table provides a summary of written and earned premium, net of reinsurance, by major product line of business for our personal insurance segment for the three and nine months ended September 30, 2009 and 2008. The one-time impact of the Pooling Change has been excluded from the nine months ended September 30, 2008 to present net written premiums on a comparative basis (see Net Written Premiums Reconciliation Table above):

(\$ millions)	Three months ended September 30			Nine months ended September 30		
	Net Written Premiums					
	2009	2008	% Change	2009	2008	% Change
<b>Personal insurance segment:</b>						
Standard Auto	\$ 120.9	103.8	16.5	\$ 345.3	297.8	16.0
Nonstandard Auto	9.2	10.8	(14.8)	29.6	33.3	(11.1)
Homeowners	69.3	61.3	13.1	185.6	166.9	11.2
Other personal	7.9	7.3	8.2	23.7	22.0	7.7
<i>Total personal</i>	<b>\$ 207.3</b>	183.2	13.2	<b>\$ 584.2</b>	520.0	12.3
	Three months ended September 30			Nine months ended September 30		
	Net Earned Premiums					
	2009	2008	% Change	2009	2008	% Change
<b>Personal insurance segment:</b>						
Standard auto	\$ 111.0	96.9	14.6	\$ 318.9	285.3	11.8
Nonstandard auto	9.5	10.7	(11.2)	29.6	32.3	(8.4)
Homeowners	58.5	53.0	10.4	169.7	160.8	5.5
Other personal	7.9	7.0	12.9	23.0	21.2	8.5
<i>Total personal</i>	<b>\$ 186.9</b>	167.6	11.5	<b>\$ 541.2</b>	499.6	8.3

Standard personal auto net written premiums for the three and nine months ended September 30, 2009, increased 16.5% and 16.0%, respectively, compared to the same 2008 periods. The State Auto Group's expansion of its operations within four of our newer states, Texas, Colorado, Arizona and Connecticut, has contributed to approximately one-third of our premium growth in standard personal auto. We believe our new products and advanced technology have strengthened our position with our independent agencies and make us attractive to prospective policyholders looking for greater value in their insurance products. Our auto product, CustomFit, coupled with easier quote capabilities, has resulted in a significant increase in new business quotes in the first nine months of 2009 compared to the same 2008 period. While the number of

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

new business quotes is higher, our issue to quote ratio has remained relatively consistent with prior years. Recent rate increases have also contributed approximately 3% to premium growth for the nine months ended September 30, 2009, compared to the same 2008 period.

Nonstandard auto net written premium for the three and nine months ended September 30, 2009, decreased 14.8% and 11.1%, respectively, compared to the same 2008 periods. In 2008, we began increasing rates and tightening underwriting controls, and in 2009, we began terminating certain agencies that failed to consistently perform to our expectations. During the third quarter 2009, we implemented premium rate increases in three of our operating states, which will result in an average premium rate increase of 5.1% in those states. Rate actions coupled with agency terminations and the impact of general economic conditions have resulted in a reduction of nonstandard new business.



**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Homeowners net written premiums for the three and nine months ended September 30, 2009, increased 13.1% and 11.2%, respectively, compared to the same 2008 periods. Rate increases in several states have contributed to this premium growth, as well as the expansion of new business in Texas, Colorado, Arizona and Connecticut. We implemented rate changes in ten of our operating states during the third quarter 2009, which will result in an average premium rate increase of 7.3% in affected states. We continue to aggressively address our rate needs in this line of business, and we are seeking higher rates for the remainder of 2009 and into 2010.

Our strategy to grow our personal lines business includes introducing our products, enhanced systems and easier technologies into new states. We introduced our standard auto product and technologies into Connecticut during the first half of 2009, and followed with the introduction of our homeowners product in that state during the third quarter 2009.

*Business Insurance Segment Revenue*

We focus our business insurance sales on small-to-medium sized businesses within the commercial insurance market and offer a broad range of both property and liability coverages. The following table provides a summary of written and earned premiums, net of reinsurance, by major product line for the three and nine months ended September 30, 2009 and 2008. The one-time impact of the Pooling Change has been excluded from the nine months ended September 30, 2008, to present net written premiums on a comparative basis (see Net Written Premiums Reconciliation Table above):

(\$ millions)	Three months ended September 30			Nine months ended September 30		
	2009	2008	% Change	2009	2008	% Change
	Net Written Premiums					
Business insurance segment:						
Commercial auto	\$ 24.1	27.0	(10.7)	\$ 77.3	82.9	(6.8)
Commercial multi-peril	23.4	25.0	(6.4)	72.5	76.2	(4.9)
Fire & allied lines	25.0	24.5	2.0	74.4	71.8	3.6
Other & product liability	17.4	19.4	(10.3)	56.4	62.0	(9.0)
Workers compensation	10.6	12.1	(12.4)	34.7	34.8	(0.3)
Other commercial	6.5	6.6	(1.5)	19.9	22.4	(11.2)
<i>Total business</i>	<b>\$ 107.0</b>	114.6	(6.6)	<b>\$ 335.2</b>	350.1	(4.3)

	Three months ended September 30			Nine months ended September 30		
	2009	2008	% Change	2009	2008	% Change
	Net Earned Premiums					
Business insurance segment:						
Commercial auto	\$ 26.4	27.7	(4.7)	\$ 80.5	83.0	(3.0)
Commercial multi-peril	24.1	24.3	(0.8)	72.1	73.7	(2.2)
Fire & allied lines	24.8	23.0	7.8	72.8	70.6	3.1

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

Other & product liability	<b>18.6</b>	20.0	(7.0)	<b>57.1</b>	60.4	(5.5)
Workers compensation	<b>10.9</b>	11.1	(1.8)	<b>33.2</b>	32.2	3.1
Other commercial	<b>6.6</b>	7.0	(5.7)	<b>20.0</b>	21.5	(7.0)
<i>Total business</i>	<b>\$ 111.4</b>	113.1	(1.5)	<b>\$ 335.7</b>	341.4	(1.7)

The business insurance segment net written premium decreased 6.6% and 4.3% for the three and nine months ended September 30, 2009, respectively, when compared to the same 2008 periods. Business insurance continues to be impacted by rate competition and general economic conditions, as well as ease of doing business issues. We believe it will be difficult to generate measurable growth given the impact of the economy on premium bases such as payrolls, sales and number of vehicles. However, we are seeking to balance our traditional underwriting discipline with new products and pricing tools that support the production of profitable new business.

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

We continue to invest in products, processes and systems that we believe will increase our business insurance writings. For our property and liability business, we have implemented a pricing process that we believe will help us price risks at appropriate levels and improve account retention; we are pursuing the same for our commercial auto and workers' compensation lines of business. In addition, we have broadened our property, liability, auto and workers' compensation pricing ranges to improve our ability to recognize the spectrum of risks within our markets. We are also attempting to strengthen our premium per exposure by re-evaluating and adjusting the application of debits and credits on our renewal policies.

We continue to enhance our insurance policy administration system, to make it easier for our agents to quote and submit business insurance policies to us. Our system now allows transactions to be processed throughout the day using real-time and straight-through processing rather than in large batch cycles at night. We have leveraged this functionality with bizXpress<sup>SM</sup>, our web-based quote system to give agents the ability to quote businessowners and commercial auto risks on-line.

We are working to expand the scope of bizXpress to add new products and lines of business, including workers' compensation. We believe this technology investment should better position us for revenue growth opportunities in the future and start to drive efficiencies into our business model much like we have seen in personal insurance. The majority of all transactions in business insurance utilize the straight-through processing technology. This has resulted in faster delivery of policies to our agents and their insureds for new business and endorsements.

We are also expanding the eligibility of our businessowners product 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, offering them in our businessowners program leverages our bizXpress technology, simplifies agents' rating and submission processes, and offers broader base coverages for these types of risks. In the third quarter 2009, we began to renew in-force Utah businessowners policies into this enhanced product and will expand it to new accounts in the fourth quarter. We plan to introduce this product enhancement to most other states within the first six months of 2010.

Similar to our personal lines segment, we are expanding our product offerings in our newer states of operations. We are leveraging our relationship with the agency distribution channel as a result of State Auto Mutual's affiliation with the Patrons Insurance Group. We introduced our commercial package, auto and workers' compensation products in Connecticut in the first quarter of 2009. In the second quarter 2009, we began to offer these products with risks located in the District of Columbia and Delaware. Four of our relatively newer states, Texas, Colorado, Arizona, and Connecticut, have contributed approximately 2% to our premium growth in 2009.

*Loss and LAE*

Our GAAP Loss and LAE ratio was 68.3% and 74.6% for the three and nine months ended September 30, 2009, respectively, as compared to 82.4% and 81.1% for the same 2008 periods. Catastrophe losses for the three and nine months ended September 30, 2009 totaled \$10.8 million (3.6 loss ratio points) and \$91.5 million (10.4 loss ratio points), respectively, compared to \$54.7 million (19.5 loss ratio points) and \$166.5 million (19.8 loss ratio points), respectively, for the same 2008 periods. During the three and nine months ended September 30, 2009, we experienced losses from 9 and 26 different storms, respectively, that were classified as numbered catastrophes by ISO's Property Claim Services (PCS) unit, a nationally recognized industry service, compared to 10 and 34 storms, respectively, for the same 2008 periods. PCS defines catastrophes as events resulting in \$25.0 million or more in insured losses industry-wide and affecting significant numbers of insureds and insurers. The losses from these catastrophes have had a significant impact on both our personal and business insurance property lines.

As of January 1, 2009, members of the State Auto Group entered into a property catastrophe aggregate excess of loss reinsurance agreement (Aggregate Treaty). Events covered by the Aggregate Treaty must be PCS numbered catastrophes, excluding earthquakes and named storms such as hurricanes and tropical storms. Individual occurrences are capped at \$55.0 million and are subject to a \$5.0 million franchise deductible. Subject to these limitations, qualifying losses from individual occurrences are then aggregated over the course of the reinsurance

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

term January 1, 2009 through December 31, 2009. On an aggregate basis, the members of the State Auto Group retain the first \$80.0 million of the covered losses, with a 25% co-participation with the reinsurer on the next \$30.0 million of covered loss. The reinsurer is responsible for 75% of the excess over \$80.0 million up to \$110.0 million of covered loss on an aggregate basis. Seven catastrophes experienced during 2009 met the minimum \$5.0 million requirement and in aggregate exceeded the State Auto Group's \$80 million retention level. Our share of recoveries under the Aggregate Treaty for the three and nine months ended September 30, 2009 was \$4.9 million and \$12.5 million, respectively, benefitting our loss ratio by 1.6 points and 1.4 points for those periods, respectively.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following tables provide our insurance segments' comparative SAP Loss and LAE ratios (loss ratios) by major lines of business for the three and nine months ended September 30, 2009 and 2008, with the catastrophe (cat) and non-catastrophe (non-cat) impact shown separately:

2009 Statutory Loss and LAE Ratios	(\$ millions)				%			
	Three months ended September 30	Earned Premium	Cat Loss & LAE	Non-Cat Loss & LAE	Statutory Loss & LAE	Cat Loss and LAE Ratio	Non-Cat Loss and LAE Ratio	Total Loss and LAE Ratio
Personal insurance segment:								
Standard auto	\$ 111.0	\$ 0.9	\$ 75.7	\$ 76.6	0.8	68.2	69.0	
Nonstandard auto	9.5	(0.1)	6.5	6.4	(0.6)	67.8	67.2	
Homeowners	58.5	9.5	32.2	41.7	16.3	55.0	71.3	
Other personal	7.9	0.1	3.3	3.4	0.7	41.9	42.6	
<i>Total personal</i>	<b>186.9</b>	<b>10.4</b>	<b>117.7</b>	<b>128.1</b>	<b>5.6</b>	<b>62.9</b>	<b>68.5</b>	
Business insurance segment:								
Commercial auto	26.4	0.1	15.1	15.2	0.3	57.2	57.5	
Commercial multi-peril	24.1	0.7	16.7	17.4	3.1	68.9	72.0	
Fire & allied lines	24.8	(0.3)	13.8	13.5	(1.2)	55.8	54.6	
Other & product liability	18.6		15.3	15.3		82.5	82.5	
Workers compensation	10.9		9.2	9.2		84.6	84.6	
Other commercial	6.6	(0.1)	2.6	2.5	(2.1)	39.1	37.0	
<i>Total business</i>	<b>111.4</b>	<b>0.4</b>	<b>72.7</b>	<b>73.1</b>	<b>0.3</b>	<b>65.3</b>	<b>65.6</b>	
<i>Total SAP personal and business</i>	<b>\$ 298.3</b>	<b>\$ 10.8</b>	<b>\$ 190.4</b>	<b>\$ 201.2</b>	<b>3.6</b>	<b>63.8</b>	<b>67.4</b>	

2008 Statutory Loss and LAE Ratios	(\$ millions)				%			
	Three months ended September 30	Earned Premium	Cat Loss & LAE	Non-Cat Loss & LAE	Statutory Loss & LAE	Cat Loss and LAE Ratio	Non-Cat Loss and LAE Ratio	Total Loss and LAE Ratio
Personal insurance segment:								
Standard auto	\$ 96.9	\$ 2.0	\$ 62.6	\$ 64.6	2.1	64.5	66.6	
Nonstandard auto	10.7		6.1	6.1	0.2	57.0	57.2	
Homeowners	53.0	37.0	29.7	66.7	69.9	56.1	126.0	
Other personal	7.0	2.1	5.3	7.4	30.1	75.0	105.1	
<i>Total personal</i>	<b>167.6</b>	<b>41.1</b>	<b>103.7</b>	<b>144.8</b>	<b>24.6</b>	<b>61.8</b>	<b>86.4</b>	

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

<b>Business insurance segment:</b>							
Commercial auto	27.7	0.2	18.8	19.0	0.8	67.9	68.7
Commercial multi-peril	24.3	3.3	14.0	17.3	13.8	57.5	71.3
Fire & allied lines	23.0	10.0	12.6	22.6	43.4	55.0	98.4
Other & product liability	20.0		14.7	14.7		73.3	73.3
Workers compensation	11.1		9.1	9.1		82.2	82.2
Other commercial	7.0	0.1	2.6	2.7	0.5	37.4	37.9
<i>Total business</i>	113.1	13.6	71.8	85.4	12.0	63.5	75.5
<i>Total SAP personal and business</i>	\$ 280.7	\$ 54.7	\$ 175.5	\$ 230.2	19.5	62.5	82.0

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

(\$ millions) %

**2009 Statutory Loss and LAE Ratios**

Nine months ended September 30	Earned Premium	Cat Loss & LAE	Non-Cat Loss & LAE	Statutory Loss & LAE	Cat Loss and LAE Ratio	Non-Cat Loss and LAE Ratio	Total Loss and LAE Ratio
<b>Personal insurance segment:</b>							
Standard auto	\$ 318.9	\$ 4.6	\$ 213.7	\$ 218.3	1.5	67.0	68.5
Nonstandard auto	29.6	0.3	22.1	22.4	0.8	74.7	75.5
Homeowners	169.7	63.9	107.8	171.7	37.7	63.5	101.2
Other personal	23.0	3.2	8.1	11.3	13.7	35.3	49.0
<i>Total personal</i>	<b>541.2</b>	<b>72.0</b>	<b>351.7</b>	<b>423.7</b>	<b>13.3</b>	<b>65.0</b>	<b>78.3</b>
<b>Business insurance segment:</b>							
Commercial auto	80.5	0.6	43.0	43.6	0.7	53.4	54.1
Commercial multi-peril	72.1	5.8	42.0	47.8	8.1	58.2	66.3
Fire & allied lines	72.8	12.9	47.7	60.6	17.7	65.6	83.3
Other & product liability	57.1		41.3	41.3		72.5	72.5
Workers compensation	33.2		25.5	25.5		76.8	76.8
Other commercial	20.0	0.2	7.8	8.0	0.8	39.5	40.3
<i>Total business</i>	<b>335.7</b>	<b>19.5</b>	<b>207.3</b>	<b>226.8</b>	<b>5.8</b>	<b>61.8</b>	<b>67.6</b>
<i>Total SAP personal and business</i>	<b>\$ 876.9</b>	<b>\$ 91.5</b>	<b>\$ 559.0</b>	<b>\$ 650.5</b>	<b>10.4</b>	<b>63.8</b>	<b>74.2</b>

(\$ millions) %

**2008 Statutory Loss and LAE Ratios**

Nine months ended September 30	Earned Premium	Cat Loss & LAE	Non-Cat Loss & LAE	Statutory Loss & LAE	Cat Loss and LAE Ratio	Non-Cat Loss and LAE Ratio	Total Loss and LAE Ratio
<b>Personal insurance segment:</b>							
Standard auto	\$ 285.3	\$ 8.5	\$ 185.4	\$ 193.9	3.0	65.0	68.0
Nonstandard auto	32.3	0.3	23.2	23.5	1.0	71.8	72.8
Homeowners	160.8	98.4	88.6	187.0	61.2	55.1	116.3
Other personal	21.2	7.5	11.5	19.0	35.4	54.3	89.7
<i>Total personal</i>	499.6	114.7	308.7	423.4	23.0	61.7	84.7
<b>Business insurance segment:</b>							
Commercial auto	83.0	0.8	51.1	51.9	1.0	61.5	62.5
Commercial multi-peril	73.7	17.8	47.3	65.1	24.2	64.1	88.3
Fire & allied lines	70.6	32.1	36.8	68.9	45.5	52.0	97.5
Other & product liability	60.4		40.5	40.5		67.0	67.0
Workers compensation	32.2		21.2	21.2		66.1	66.1
Other commercial	21.5	1.1	6.5	7.6	4.8	30.7	35.5

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

<i>Total business</i>	341.4	51.8	203.4	255.2	15.2	59.5	74.7
<i>Total SAP personal and business</i>	\$ 841.0	\$ 166.5	\$ 512.1	\$ 678.6	19.8	60.9	80.7



**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

In the personal insurance segment, the overall non-cat loss and LAE ratios for the three and nine months ended September 30, 2009 increased 1.1 and 3.3 points, respectively, from the same 2008 periods.

Standard auto experienced increases in its non-cat loss and LAE ratios for the three and nine months ended September 30, 2009, of 3.7 and 2.0 points, respectively, from the same 2008 periods. These increases were the result of an increase in the overall severity of losses. Previously, the intense price competition in the personal lines market had impeded our ability to take appropriate rate increases. However, we believe price competition in the personal lines market is becoming less intense, as we are experiencing premium growth due to recent rate increases, and we intend to continue to seek price increases in the mid single-digit range in 2010.

Our homeowners non-cat loss and LAE ratio decreased 1.1 points for the three months ended September 30, 2009, while increasing 8.4 points for the nine months ended September 30, 2009, when compared to the same 2008 periods. The increase for the nine months was driven by an increase in non-cat weather losses. In homeowners, we continue to seek rate increases in various states as appropriate for that state. However, there is no assurance that the regulatory authorities will grant our requested rate increases or that the regulatory authorities will grant any rate increase. In addition to pricing actions and the Aggregate Treaty implemented earlier this year, we have implemented mandatory wind and hail deductibles in approximately one-third of our operating states and are in the process of strengthening our insurance-to-value program. In addition, we intend to implement commission reductions beginning in 2010 and will introduce our new by-peril homeowner rating product in the fourth quarter of 2009.

In the business insurance segment, the non-cat loss and LAE ratios for the three and nine months ended September 30, 2009, increased 1.8 points and 2.3 points, respectively, from the same 2008 periods. The non-cat commercial auto loss and LAE ratios for the three and nine months ended September 30, 2009 decreased 10.7 points and 8.1 points, respectively, from the same 2008 periods due primarily to a decrease in the number and size of large liability losses. The non-cat commercial multi-peril loss and LAE ratio increased 11.4 points for the three months ended September 30, 2009, compared to the same 2008 period, due primarily to adverse development on losses from prior accident years. The non-cat commercial multi-peril loss and LAE ratio for the nine months ended September 30, 2009 decreased 5.9 points, compared to the same 2008 period, due primarily to a decrease in the number and size of large losses. Our non-cat fire and allied lines loss and LAE ratio for the three months ended September 30, 2009 increased 0.8 points, while increasing 13.6 points for the nine months ended September 30, 2009, when compared to the same 2008 periods. The increase for the nine months was primarily due to several large fire losses in the first half of the year. The increases in the other and product liability loss and LAE ratios for the three and nine months ended September 30, 2009 of 9.2 and 5.5 points, respectively, from the same 2008 periods were driven by increases in large losses and in the overall severity of losses. The workers compensation non-cat loss and LAE ratios for the three and nine months ended September 30, 2009, increased 2.4 points and 10.7 points, respectively, from the same 2008 periods. The frequency of losses in workers compensation has decreased, while large loss activity and the severity of losses overall have increased for both the three and nine months ended September 30, 2009, as compared to the same 2008 periods.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Loss and loss expenses payable by major line of business at September 30, 2009, and December 31, 2008, respectively, are shown in the following table:

<i>(\$ millions)</i>	<b>September 30, 2009</b>	December 31, 2008	\$ Change
<b>Personal insurance segment:</b>			
Standard auto	<b>\$ 208.0</b>	188.5	\$ 19.5
Nonstandard auto	<b>19.9</b>	19.6	0.3
Homeowners	<b>75.2</b>	68.6	6.6
Other personal	<b>14.8</b>	14.6	0.2
<i>Total personal</i>	<b>317.9</b>	291.3	26.6
<b>Business insurance segment:</b>			
Commercial auto	<b>92.8</b>	93.5	(0.7)
Commercial multi-peril	<b>93.4</b>	91.5	1.9
Fire & allied lines	<b>36.6</b>	38.6	(2.0)
Product & other liability	<b>166.6</b>	152.3	14.3
Workers compensation	<b>102.2</b>	97.1	5.1
Other business	<b>5.5</b>	5.7	(0.2)
<i>Total business</i>	<b>497.1</b>	478.7	18.4
<i>Total losses and loss expenses payable net of reinsurance recoverable on losses and loss expenses payable</i>	<b>\$ 815.0</b>	770.0	45.0

Loss and loss expenses payable increased \$45.0 million since December 31, 2008 primarily due to growth in exposures in our standard auto and homeowners business and an increase in the number of outstanding losses in our product and other liability line. 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 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 Other Loss and Loss Expense Reserves in Item 7 of the 2008 Form 10-K.

*Expenses*

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

Acquisition and operating expenses, as a percentage of earned premiums ( GAAP expense ratio ), were 34.2% and 33.7% for the three and nine months ended September 30, 2009, respectively, compared to 33.8% and 33.4%, respectively, for the same 2008 periods. The ratios increased primarily due to costs associated with the reorganization of our field and claims operations described below, which contributed 0.6 and 0.3 points, respectively, to the expense ratios for the three and nine months ended September 30, 2009.

As a result of Innovate SA, in the second quarter of 2009, we initiated a plan to reorganize our field and claims operations. We anticipate that reorganizing our field and claims operations will allow us to improve service, streamline workflows and better deploy new technology solutions. Under our reorganization plan, the existing field regions will be merged into five new regions, each with a regional headquarters, which we believe will allow us to be more responsive to our agents. Each region will support personal insurance sales and business insurance sales, underwriting, processing and administrative functions. Personal insurance underwriting, support, processing and administrative functions will be consolidated into two operation centers.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

As part of the reorganization of our claims operations, we will expand our dedicated catastrophe team to address both the urgency and special needs of catastrophe claim handling. Many large property losses, which have been generally sent out to independent adjusters, will be handled in-house by large property specialist adjusters strategically placed throughout our operating states. New contact center property claim teams will be organized with redefined responsibilities including adjusting contents claims for larger fire losses and supporting the dedicated catastrophe team. In addition, we expect to hire additional automobile and property appraisers to rely less on outside property and auto appraisers. We believe this will allow us to take advantage of current technology by having many of our property and auto appraisers work from their homes, providing better access to policyholders. Casualty claims will continue to be handled in-house in fewer, larger units. We believe that having more people in fewer locations will allow us to better train new casualty claim handlers, staff more flexibly, and provide closer supervision on longer tail, third party claims.

Total restructuring charges, including employee termination benefits, relocation packages, and costs associated with ceasing to use leased properties, are estimated to be approximately \$9.4 million through the fourth quarter 2010, the expected completion date for the reorganization. For the three and nine months ended September 30, 2009, we recognized restructuring charges of \$3.2 million and \$4.2 million, respectively. In addition, due to an estimated reduction in expected years of future service of those impacted employees, in 2009 we recognized a reduction of \$13.1 million in our benefit plan liabilities, benefitting our accumulated other comprehensive loss by \$8.6 million, after tax. See Note 8 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

**Investment Operations Segment**

At September 30, 2009, all investments in fixed maturity and equity securities and certain other invested assets were 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 in accumulated other comprehensive loss 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—2008 Compared to 2007—Investment Operations Segment in Item 7 of the 2008 Form 10-K.

*Composition of Investment Portfolio*

The following table provides the composition of our available-for-sale investment portfolio at fair value at September 30, 2009, and December 31, 2008, respectively:

<i>(\$ millions)</i>	<b>September 30, 2009</b>		December 31, 2008	
Fixed maturities	<b>\$ 1,844.0</b>	<b>89.5%</b>	1,770.7	91.3
Equity securities	<b>175.3</b>	<b>8.5</b>	137.5	7.1
Other invested assets	<b>41.2</b>	<b>2.0</b>	31.7	1.6
<i>Total available-for-sale investments</i>	<b>\$ 2,060.5</b>	<b>100.0%</b>	1,939.9	100.0

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The amortized cost and fair value of fixed maturities at September 30, 2009, by contractual maturity, are as follows:

<i>(\$ millions)</i>	Amortized cost	Fair value
Due in 1 year or less	\$	
Due after 1 year through 5 years	141.4	145.8
Due after 5 years through 10 years	527.6	549.9
Due after 10 years	816.1	848.1
U.S. government agencies residential mortgage-backed securities	290.8	300.2
<i>Total</i>	\$1,755.9	1,844.0

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 following table provides a breakdown of our investment portfolio percentages at September 30, 2009, and December 31, 2008, relative to our targeted asset allocation.

<i>(\$ millions)</i>	<b>September 30, 2009</b>	<b>% of Total</b>	December 31, 2008	% of Total	Target %
Cash and cash equivalents	\$ 102.1	4.7	\$ 150.5	7.2	3.5
Fixed maturities, at amortized cost:					
Fixed maturities	1,657.7	76.5	1,703.2	81.0	
Notes receivable from affiliate	70.0	3.2			
<i>Total core fixed maturities</i>	1,727.7	79.7	1,703.2	81.0	69.0
Treasury inflation protected securities	118.2	5.5	77.9	3.7	10.0
<i>Total fixed maturities</i>	1,845.9	85.2	1,781.1	84.7	79.0
Equities, at fair value:					
Large-cap equities	160.2	7.4	130.2	6.2	10.5
Small-cap equities	15.1	0.7	7.3	0.3	3.0
<i>Total equities</i>	175.3	8.1	137.5	6.5	13.5
Other invested assets, at fair value:					
International instruments	37.3	1.7	28.8	1.4	4.0
Other invested assets	3.9	0.2	2.9	0.1	
<i>Total other invested assets, at fair value</i>	41.2	1.9	31.7	1.5	4.0
Other invested assets, at cost:					

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

Other invested assets	<b>1.6</b>	<b>0.1</b>	1.4	0.1	
<i>Total portfolio</i>	\$ <b>2,166.1</b>	<b>100.0</b>	\$ 2,102.2	100.0	100.0

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

In May 2009, two of State Auto Financial's subsidiaries, State Auto P&C and Milbank, entered into separate Credit Agreements with State Auto Mutual. Under these Credit Agreements, State Auto Mutual borrowed a total of \$70.0 million from State Auto P&C and Milbank (\$50.0 million and \$20.0 million, respectively) on an unsecured basis. Interest is payable semi-annually at a fixed annual interest rate of 7.00%. Principal is payable May 2019.

*Investment Operations Revenue*

Net investment income for the three and nine months ended September 30, 2009 decreased \$1.4 million and \$7.0 million, respectively, from the same 2008 periods. In addition, our investment yield for the three and nine months ended September 30, 2009 declined to 4.2% and 3.9%, respectively, from 4.3% and 4.2% in the same 2008 periods, respectively. These declines were primarily due to the following factors.

From September 30, 2008 to September 30, 2009, our Treasury Inflation Protection Securities ( TIPS ) exposure, at amortized cost, increased to \$118.2 million from \$71.4 million, respectively. During the first nine months of 2009, the income earned on our TIPS securities, which is dependent on changes in the CPI Index, declined when compared to the same 2008 period.

For the three and nine months ended September 30, 2009, we held fewer large-cap dividend paying stocks compared to the same 2008 periods.

Dividend payouts were reduced on certain equity holdings.

On average, we held higher levels of cash balances for the nine months ended September 30, 2009, which earned lower yields than the nine months ended September 30, 2008. Average short-term yields were 250 basis points lower in the first nine months of 2009 than in the same 2008 period.

(\$ millions)	Three months ended		Nine months ended	
	September 30 2009	2008	September 30 2009	2008
<b>Gross investment income:</b>				
Fixed income securities	\$ 19.8	21.5	\$ 56.4	61.3
Equity securities	0.8	1.1	2.5	3.6
Other	1.4	1.0	3.3	4.5
<b>Total gross investment income</b>	<b>22.0</b>	23.6	<b>62.2</b>	69.4
Investment expenses	0.4	0.6	1.5	1.7
<b>Net investment income</b>	<b>\$ 21.6</b>	23.0	<b>\$ 60.7</b>	67.7
Average invested assets (at cost)	\$ 2,043.9	2,136.8	\$ 2,065.5	2,136.3
Annualized investment yield	4.2%	4.3	3.9%	4.2
Annualized investment yield, after tax	3.6%	3.7	3.4%	3.7
Net investment income, after tax	\$ 18.3	20.0	\$ 52.9	58.9
Effective tax rate	15.3%	13.3	12.8%	13.1

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Realized gains and losses on investment sales are summarized as follows:

<i>(\$ millions)</i>	Three months ended September 30, 2009		Nine months ended September 30, 2009	
	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale
<b>Realized gains:</b>				
Fixed maturities	\$ 2.0	\$ 94.3	\$ 5.2	\$ 281.4
Equity securities	2.7	9.7	4.0	15.8
<i>Total realized gains</i>	4.7	104.0	9.2	297.2
<b>Realized losses:</b>				
Fixed maturities		1.4	(0.1)	1.6
<b>Equity securities:</b>				
Sales	(0.2)	0.5	(6.4)	11.9
OTTI	(0.9)		(7.9)	
<i>Total realized losses</i>	(1.1)	1.9	(14.4)	13.5
<i>Net realized gains (losses) on investments</i>	\$ 3.6	\$ 105.9	\$ (5.2)	\$ 310.7

During the three and nine months ended September 30, 2009, we sold fixed maturities, which resulted in realized gains on certain municipal bonds, and replaced them with taxable bonds.

During the three and nine months ended September 30, 2009, equity sales were executed for various reasons, including the achievement of our price target. For the third quarter 2009, we realized losses of \$0.2 on the sale of our externally managed small-cap equity portfolio. During the six months ended June 30, 2009, we realized losses of \$6.2 million on the sale of equity securities in response to negative earnings or negative outlook announcements and changes in business conditions which in our opinion diminished their future business prospects.

We regularly monitor our investment portfolio for declines in value that are OTTI, an assessment which 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 herein. We consider the following factors when assessing our equity securities and other invested assets for OTTI: (1) the length of time and/or the significance of decline below cost; (2) our ability and intent to hold these securities through their recovery periods; (3) the current financial condition of the issuer and its future business prospects; and (4) the ability of the market value to recover to cost in the near term. We recognize OTTI charges on our externally managed small-cap equity portfolio and a segment of our large-cap portfolio, as we are unable to make the assertion regarding our intent to hold these securities that are currently valued below cost until recovery 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, we adjust the cost basis of the security 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 (loss).



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

We also consider the following factors when assessing our fixed maturities investments for OTTI: (1) the financial condition of the issuer; (2) our intent to sell; and (3) if it is more likely than not that we will be required to sell the investments before recovery. When a fixed maturity has been determined to have a 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 (loss). Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income (loss). We did not recognize OTTI on our fixed maturity portfolio during the first nine months of 2009 or 2008.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following table provides a detailed breakdown by security type (and by sector for the large-cap portfolio) for the three and nine months ended September 30, 2009, of our OTTI charges.

(\$ millions, except # of positions)	Three months ended September 30, 2009		Nine months ended September 30, 2009	
	Number of positions	Total impairment	Number of positions	Total impairment
Equity securities:				
Large-cap equities:				
Energy		\$	1	\$ (0.4)
Financial services			2	(0.8)
Industrial and materials	1	(0.8)	8	(5.7)
<i>Total large-cap equities</i>	1	(0.8)	11	(6.9)
Small-cap equities	13	(0.1)	258	(1.0)
<i>Total OTTI</i>	14	\$ (0.9)	269	\$ (7.9)

*Gross Unrealized Investment Gains and Losses*

Based upon our review of our investment portfolio at September 30, 2009, 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. We also determined that there were no individual material securities with an unrealized holding loss at September 30, 2009.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following table provides detailed information on our available-for-sale investment portfolio for our gross unrealized gains and losses, adjusted for investments with OTTI at September 30, 2009:

(\$ 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>Investment Category:</b>						
<b>Fixed Maturities:</b>						
U.S. treasury securities	\$ 261.3	\$ 5.3	65	\$ (0.3)	11	\$ 266.3
States & political subdivisions	1,129.5	51.0	496	(0.5)	14	1,180.0
Corporate securities	94.3	3.2	51		3	97.5
U.S. government agencies residential mortgage-backed securities	290.8	9.8	92	(0.4)	12	300.2
<i>Total fixed maturities</i>	1,775.9	69.3	704	(1.2)	40	1,844.0
<b>Equity Securities:</b>						
<b>Large-cap equity securities:</b>						
Consumer	40.5	7.2	13	(0.4)	4	47.3
Technological	36.7	6.4	11	(0.8)	4	42.3
Industrial and materials	35.9	5.5	13	(0.7)	3	40.7
Energy	17.2	1.3	5	(1.2)	3	17.3
Financial services	7.7	2.7	4		1	10.4
Utilities	2.2				2	2.2
<i>Total large-cap equity securities</i>	140.2	23.1	46	(3.1)	17	160.2
Small-cap equity securities	13.5	1.6	124			15.1
<i>Total equity securities</i>	153.7	24.7	170	(3.1)	17	175.3
Other invested assets	34.2	7.0	4			41.2
<i>Total investments</i>	\$ 1,963.8	\$ 101.0	878	\$ (4.3)	57	\$ 2,060.5

The following table presents the detail of our cumulative unrealized holding gains (losses) by investment type, net of deferred taxes that were included as a component of accumulated other comprehensive loss at September 30, 2009, and December 31, 2008, respectively, and the change in unrealized holding gains, net of deferred tax for the nine months ended September 30, 2009.

(\$ millions)	September 30, 2009	December 31, 2008	\$ Change
Available-for-sale investments:			

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

Cumulative unrealized holding gain (loss):			
Fixed maturities	\$ 68.1	\$ (10.4)	\$ 78.5
Equities	21.6	(6.8)	28.4
Other invested assets	7.0	(0.7)	7.7
<i>Cumulative unrealized holding gain (loss)</i>	<b>96.7</b>	(17.9)	114.6
Deferred federal income tax (liability) asset	<b>(33.8)</b>	6.3	(40.1)
Valuation allowance		(2.6)	2.6
<i>Cumulative unrealized holding gain (loss), net of tax</i>	<b>\$ 62.9</b>	\$ (14.2)	\$ 77.1

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

At September 30, 2009, we determined a valuation allowance was not needed because our cumulative unrealized holding loss at December 31, 2008, had shifted to a cumulative unrealized holding gain. In the first quarter of 2009, we reversed the \$3.1 million valuation allowance that we established at December 31, 2008, benefitting accumulated other comprehensive loss by \$2.6 million and deferred tax expense by \$0.5 million.

*Fair Value Measurements*

For financial statement elements currently required to be measured at fair value, the Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification ( ASC ) defines fair value, establishes a framework for measuring fair value under GAAP and enhances disclosures about fair value measurements. The definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (exit price) regardless of whether an observable liquid market price exists. An exit price valuation will include margins for risk even if they are not observable.

The fair value hierarchy categorizes the inputs to valuation techniques which are used to measure fair value into three broad levels as defined below.

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).

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.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The table below shows our investments by Level at September 30, 2009:

<i>(\$ millions)</i>	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Available-for-sale investments:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 266.3		266.3	
Obligations of states and political subdivisions	1,180.0		1,180.0	
Corporate securities	97.5		95.1	2.4
U.S. government agencies residential mortgage-backed securities	300.2		300.2	
<i>Total fixed maturities</i>	1,844.0		1,841.6	2.4
Equity securities:				
Large-cap equity securities:				
Consumer	47.3	47.3		
Technological	42.3	42.3		
Industrial and materials	40.7	40.7		
Energy	17.3	17.3		
Financial services	10.4	10.4		
Utilities	2.2	2.2		
<i>Total large-cap equity securities</i>	160.2	160.2		
Small-cap equity securities	15.1	15.1		
<i>Total equity securities</i>	175.3	175.3		
Other invested assets	41.2	3.9		37.3
<i>Total available-for-sale investments</i>	\$ 2,060.5	179.2	1,841.6	39.7

As of September 30, 2009, Level 3 assets as a percentage of total assets were 1.5%, 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 Income Statement Items***

Interest expense on our debt was \$1.8 million and \$5.6 million versus \$1.8 million and \$5.5 million for the three and nine months ended September 30, 2009 and 2008, respectively.

Income before federal income taxes for the three months ended September 30, 2009 was \$13.7 million compared to a loss before federal income taxes of \$30.2 million for the same 2008 period. Loss before federal income taxes for the nine months ended September 30, 2009 was \$28.9 million compared to \$69.4 million, for the same 2008 period. The pre-tax income for the third quarter and the decrease in the pre-tax loss for the first nine months of 2009 was primarily the result of the increase in earned premium and a decrease in catastrophe storm losses. The uncertainty of our expected 2009 full year results precludes us from making a reliable estimate of an expected full year tax rate. Accordingly, we recorded a tax benefit based on the results for the nine months ended September 30, 2009. The effective tax rate differs from the statutory rate of 35% principally because of tax exempt investment income. The effective tax rate for the three and nine months ended September 30, 2009 was an expense of 5.1% and a benefit of 85.5%, respectively.

**LIQUIDITY AND CAPITAL RESOURCES**

Liquidity refers to our ability to generate adequate amounts of cash to meet our needs to pay both short and long-term cash obligations as they come due. Our significant sources of cash are premiums, investment income, investment sales and the maturity of fixed 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, along with payments made for the purchase of common shares under our stock repurchase program discussed below. The cash outflows can 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 our insurance subsidiaries to meet anticipated short and long-term cash requirements without the need to sell investments to meet fluctuations in their operating cash flow or the cash flow needs of State Auto Financial.

At September 30, 2009, and December 31, 2008, we had \$102.1 million and \$150.5 million, respectively, of cash and cash equivalents and \$2,060.5 million and \$1,939.9 million, respectively, of total investments at fair market value. Substantially all of our fixed maturity and equity securities are traded on public markets.

Net cash provided by operating activities was \$53.4 million for the first nine months of 2009 versus \$157.5 million for the same 2008 period. Cash from operations in 2008 included \$92.0 million received in conjunction with the Pooling Change. In the first nine months of 2009, claims paid exceeded premiums collected when compared to the same 2008 period. Below are additional factors that contributed to the change in operating cash flows between the two periods:

Federal income tax refund of \$12.9 million was received in 2009 compared to federal income tax payment of \$18.0 million made in 2008; and

Cash contribution to the defined benefit plan of \$15.0 million was made in 2009 compared to \$8.0 million in 2008.

Net cash used in investing activities was \$85.8 million for the first nine months of 2009 compared to \$91.7 million in the same 2008 period. The decline between the two periods was primarily due to the level of cash provided by operating activities for each of the two periods, as previously discussed.

Net cash used in financing activities was \$16.0 million for the first nine months of 2009 compared to \$47.6 million during the same 2008 period. Cash used in financing activities decreased in 2009 because we did not repurchase any common stock under our stock repurchase program

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

(discussed below), as compared to 2008 when we used cash of \$33.2 million for repurchases of common stock.

On August 14, 2009, State Auto Financial's board of directors declared a quarterly cash dividend of \$0.15 per share compared to \$0.15 per share from the same 2008 period. The dividend was payable September 30, 2009, to shareholders of record at the close of business on September 14, 2009. This was the 73<sup>rd</sup> consecutive quarterly cash dividend declared since State Auto Financial had its initial public offering in 1991.

In July 2009, Stateco declared and paid cash dividends of \$2.0 million to State Auto Financial. These dividends will be used to provide working capital to State Auto Financial.



**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

***Borrowing Arrangements***

*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.

*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 September 30, 2009 and 2008 were 4.5% and 7.0%, respectively.

*Credit Facility*

State Auto Financial has a credit facility (the Credit Facility) with a syndicate of financial institutions. The Credit Facility provides for a \$100.0 million unsecured revolving credit facility maturing in July 2012. The Credit Facility is available for general corporate purposes. The Credit Facility provides for interest-only payments during its term, with principal and interest due in full at maturity. Interest is based on a London interbank market rate or a base rate plus a calculated margin amount. The Credit Facility includes certain covenants, including financial covenants that require State Auto Financial to maintain a minimum net worth and not exceed a certain debt to capitalization ratio. As of September 30, 2009, State Auto Financial was in compliance with all covenants related to the Credit Facility. As of September 30, 2009, State Auto Financial had not made any borrowings under the Credit Facility.

***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.

As of July 1, 2009, we reviewed and renewed our property per risk, property catastrophe, casualty, workers' compensation and workers' compensation catastrophe reinsurance programs. Coverage under the property per risk excess of loss program was revised to include in the first layer, \$2.0 million excess of \$3.0 million, an additional aggregate retention of \$2.0 million per treaty year. Overall there were no material changes to the terms of the reinsurance programs renewed at July 1, 2009. The change in cost for these programs is not expected to be material to our quarter or year to date results of operations.

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

Other than those discussed above, there have been no material changes in our reinsurance arrangements from those disclosed in the 2008 Form 10-K. For a discussion of our reinsurance arrangements, see Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Reinsurance Arrangements in Item 7 of the 2008 Form 10-K.

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

***Stock Repurchase Program***

On August 17, 2007, State Auto Financial's board of directors authorized the repurchase, from time to time, of up to 4.0 million of State Auto Financial's common shares, or approximately 10% of State Auto Financial's outstanding shares, over a period extending to and through December 31, 2009 (Stock Repurchase Program). State Auto Financial will repurchase shares from State Auto Mutual in amounts that are proportional to the respective current ownership percentages of State Auto Mutual, which is approximately 64%, and other shareholders. There were no shares repurchased during the nine months ended September 30, 2009. Since inception through September 30, 2009, a total of 2,028,116 common shares have been purchased under this program at an average purchase price of \$27.26 for a total of \$55.3 million.

***Regulatory Considerations***

At September 30, 2009, all of our insurance subsidiaries were in compliance with statutory requirements relating to capital adequacy.

**ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS**

***Accounting Standards Codification***

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* a replacement of FASB Statement No. 162 (the Codification). The Codification reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private sector standard setters into a single source of authoritative accounting principles arranged by topic. The Codification supersedes all existing U.S. accounting standards; all other accounting literature not included in the Codification (other than Securities and Exchange Commission guidance for publicly-traded companies) is considered non-authoritative. The Codification was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. The adoption of the Codification changed our references to U.S. GAAP accounting standards but did not impact our consolidated financial statements.

***Subsequent Events***

In May 2009, the FASB issued new guidance for accounting for subsequent events. The new guidance, which is now part of the FASB ASC Topic Subsequent Events, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, the new guidance sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements. The new guidance was effective on a prospective basis for interim or annual periods ending after June 15, 2009. The adoption of this new guidance effective June 30, 2009 had no effect on our consolidated financial statements. The disclosures required by this new guidance are provided in Note 14 of the accompanying financial statements.

***Other-Than-Temporary Impairments***

In April 2009, the FASB issued new guidance for the accounting for other-than-temporary impairments. Under the new guidance, which is now part of the ASC Topic Investments - Debt and Equity Securities, the indicators used in considering an impairment of a debt security to be other-than-temporary have been modified, from management asserting it has both the intent and the ability to hold an impaired security for a period of time sufficient for anticipated recovery in fair value to management asserting that (a) it does not have the intent to sell the security and (b) it is more likely than not it will not have to sell the security before recovery. Additionally, this new guidance requires that other-than-temporary impairments on debt securities due to credit be recognized in earnings while non-credit other-than-temporary impairments be recognized in other comprehensive income. This new guidance also requires companies to disclose major security types for both debt and

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

equity securities and to provide meaningful disclosure about individually significant unrealized losses and all such disclosures are required to be included in both interim and annual periods. This new guidance was effective for interim and annual reporting periods ending after June 15, 2009. The adoption of this new guidance effective April 1, 2009 did not have a material effect on our consolidated financial statements. The disclosures required by this new guidance are provided in Note 2 of the accompanying financial statements.

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

*Additional Fair Value Measurement Guidance*

In April 2009, the FASB issued new guidance for determining when a transaction is not orderly and for estimating fair value when there has been a significant decrease in the volume and level of activity for an asset or liability. The new guidance, which is now part of the ASC Topic Fair Value Measurements and Disclosures, requires disclosure of the inputs and valuation techniques used, as well as any changes in valuation techniques and inputs used during the period, to measure fair value in interim and annual periods. In addition, the presentation of the fair value hierarchy is required to be presented by major security type as described in the ASC Topic Investments – Debt and Equity Securities. The provisions of the new guidance were effective for interim periods ending after June 15, 2009. The adoption of this new guidance effective April 1, 2009 did not have a material effect on our consolidated financial statements. The disclosures required by this new guidance are provided in Note 3 of the accompanying financial statements.

*Disclosures about Fair Value of Financial Instruments*

In April 2009, the FASB issued new guidance related to the disclosure of the fair value of financial instruments. The new guidance, which is now part of the ASC Topic Financial Instruments, requires disclosure of the fair value of financial instruments whether recognized or not recognized on the balance sheet in interim and annual financial statements. The provisions of the new guidance were effective for interim periods ending after June 15, 2009. We adopted this new guidance effective April 1, 2009. The disclosures required by this new guidance are provided in Notes 5 and 6 of the accompanying 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 – 2008 Compared to 2007 – Investment Operations Segment – Market Risk in Item 7 of the 2008 Form 10-K. There have been no material changes from the information reported regarding Market Risk in the 2008 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;

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

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**

None.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in the 2008 Form 10-K under Part I, Item 1A Risk Factors.

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

## Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (in whole numbers)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1)</sup>	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased under the Plans or Programs
07/01/09 thru 07/31/09		\$		1,971,884
08/01/09 thru 08/31/09				1,971,884
09/01/09 thru 09/30/09				1,971,884
Total		\$		

<sup>(1)</sup> On August 17, 2007, State Auto Financial announced that its board of directors had authorized the repurchase, from time to time, of up to 4.0 million of its common shares, or approximately 10% of State Auto Financial's outstanding shares, over a period extending until December 31, 2009. State Auto Financial will repurchase shares from State Auto Mutual in amounts that are proportional to the respective current ownership percentages of State Auto Mutual, which is approximately 64%, and other shareholders.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

**RTW Consulting Services Agreement**

State Auto Mutual owns approximately 64% of the outstanding common shares of State Auto Financial.

On October 30, 2009, State Auto Mutual and one of its insurance subsidiaries and an insurance affiliate, namely Meridian Security Insurance Company and Meridian Citizens Mutual Insurance Company, and three insurance subsidiaries of State Auto Financial, namely State Auto Property & Casualty Insurance Company, Farmers Casualty Insurance Company and Milbank Insurance Company (collectively, the "State Auto Insurers"), entered into a Consulting Services Agreement (the "RTW Consulting Services Agreement") with RTW, Inc. ("RTW"). RTW is an indirect subsidiary of State Auto Mutual. The RTW Consulting Services Agreement was subject to approval by the state insurance regulators for the States of Indiana, Iowa, Ohio and South Dakota, and the last of these regulatory approvals was received on October 30, 2009. The RTW Consulting Services Agreement was effective as of November 1, 2009.

RTW provides claims administration and consulting services to clients in the areas of workers' compensation, disability and absence management.



**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Under the RTW Consulting Services Agreement, RTW will investigate potential high risk workers compensation claims submitted by the State Auto Insurers and assign RTW nurses for ongoing case management for those claims that meet certain criteria. The RTW nurses will be responsible to coordinate case management activities with the State Auto Insurers claims adjusters. RTW may also provide workers compensation third party administrative services for the State Auto Insurers as may be mutually agreed to by the parties. RTW will be compensated for its services on either a per case, per file or per hour basis, depending upon the type of service it renders.

The initial term of the RTW Consulting Agreement ends on April 30, 2010, with an automatic annual renewal unless 60 days advance written notice of non-renewal is given by RTW or the State Auto Insurers. In addition, RTW or any of the State Auto Insurers may terminate the agreement upon 30 days advance written notice of termination, provided that termination by any State Auto Insurer shall only relate to such Insurer and will not terminate the agreement with respect to any other State Auto Insurer.

The RTW Consulting Services Agreement contains customary prohibitions concerning the disclosure of RTW's confidential information by the State Auto Insurers and indemnification provisions for damages or losses related to acts or omissions of the indemnifying party or resulting from breaches of the agreement by the indemnifying party.

A copy of the RTW Consulting Agreement is included as an exhibit to this Form 10-Q.

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Item 6. Exhibits**

Exhibit No.	Description of Exhibits
10.01	Consulting Services Agreement, effective as of November 1, 2009, by and between State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Farmers Casualty Insurance Company and Milbank Insurance Company, and RTW, Inc.
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

**Table of Contents**

**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**

Date: November 4, 2009

/s/ Steven E. English  
Steven E. English  
Chief Financial Officer  
(Duly Authorized Officer and

Principal Financial Officer)