

State Auto Financial CORP  
Form 10-Q  
November 09, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended September 30, 2011

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

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

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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 November 1, 2011, the Registrant had 40,274,009 Common Shares outstanding.

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## 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<br/>30<br/>2011</b> | December 31<br>2010 |
|---|----------------------------------|---------------------|
|   | (unaudited)                      | (see note 1)        |
| <b>Assets</b>   |                                  |                     |
| Fixed maturities, available-for-sale, at fair value<br>(amortized cost \$1,936.1 and \$1,862.3, respectively) | \$ 2,041.1                       | 1,900.7             |
| Equity securities, available-for-sale, at fair value<br>(cost \$173.5 and \$200.2, respectively)              | 182.4                            | 256.2               |
| Other invested assets, available-for-sale, at fair value<br>(cost \$56.7 and \$64.4, respectively)            | 65.3                             | 79.7                |
| Other invested assets   | 0.5                              | 0.5                 |
| Note receivable from affiliate  | 70.0                             | 70.0                |
| <i>Total investments</i>  | <b>2,359.3</b>                   | 2,307.1             |
| Cash and cash equivalents   | 186.7                            | 88.3                |
| Accrued investment income and other assets  | 31.2                             | 38.0                |
| Deferred policy acquisition costs   | 172.3                            | 150.2               |
| Reinsurance recoverable on losses and loss expenses payable<br>(affiliates none)                              | 30.3                             | 18.8                |
| Prepaid reinsurance premiums (affiliates none)  | 8.2                              | 7.6                 |
| Due from affiliate  |                                  | 6.5                 |
| Current federal income taxes  | 12.9                             | 7.6                 |
| Net deferred federal income taxes   | 0.5                              | 86.3                |
| Property and equipment, at cost   | 10.4                             | 11.6                |
| <b>Total assets</b>   | <b>\$ 2,811.8</b>                | 2,722.0             |
| <b>Liabilities and Stockholders Equity</b>  |                                  |                     |
| Losses and loss expenses payable (affiliates \$570.4 and \$375.8, respectively)                               | \$ 1,140.8                       | 893.0               |
| Unearned premiums (affiliates \$310.5 and \$234.6, respectively)  | 693.9                            | 613.2               |
| Notes payable (affiliates \$15.5 and \$15.5, respectively)  | 116.5                            | 116.8               |
| Postretirement and pension benefits   | 185.5                            | 186.9               |
| Due to affiliate  | 20.4                             |                     |
| Other liabilities   | 53.5                             | 60.3                |
| <b>Total liabilities</b>  | <b>2,210.6</b>                   | 1,870.2             |
| Stockholders equity:  |                                  |                     |

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|  |                   |         |
|--|-------------------|---------|
| 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; 47.0 and 46.9 shares issued, respectively, at stated value of \$2.50 per share | <b>117.6</b>      | 117.3   |
| Treasury stock, 6.8 and 6.8 shares, respectively, at cost  | <b>(115.8)</b>    | (115.8) |
| Additional paid-in capital   | <b>125.7</b>      | 122.1   |
| Accumulated other comprehensive income (loss)  | <b>3.0</b>        | (7.9)   |
| Retained earnings  | <b>470.7</b>      | 736.1   |
| <b><i>Total stockholders equity</i></b>  | <b>601.2</b>      | 851.8   |
| <b><i>Total liabilities and stockholders equity</i></b>  | <b>\$ 2,811.8</b> | 2,722.0 |

See accompanying notes to condensed consolidated financial statements.

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## 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<br>September 30 |              |
|--|------------------------------------|--------------|
|  | 2011                               | 2010         |
| Earned premiums (ceded to affiliates \$198.7 and \$205.7, respectively)          | \$ 356.8                           | 318.3        |
| Net investment income (affiliate \$1.3 and \$1.3, respectively)                  | 20.3                               | 19.3         |
| Net realized gain on investments:  |                                    |              |
| Total other-than-temporary impairment losses                                     | (4.4)                              | (0.6)        |
| Portion of loss recognized in other comprehensive income                         |                                    |              |
| Other net realized investment gains  | 14.6                               | 3.4          |
| Total net realized gain on investments   | 10.2                               | 2.8          |
| Other income (affiliates \$0.7 and \$0.3, respectively)                          | 0.7                                | 0.3          |
| <b>Total revenues</b>  | <b>388.0</b>                       | <b>340.7</b> |
| Losses and loss expenses (ceded to affiliates \$182.0 and \$146.3, respectively) | 315.3                              | 232.6        |
| Acquisition and operating expenses   | 121.4                              | 104.3        |
| Interest expense (affiliates \$0.1 and \$0.2, respectively)                      | 1.9                                | 1.7          |
| Other expenses   | 1.4                                | 2.3          |
| <b>Total expenses</b>  | <b>440.0</b>                       | <b>340.9</b> |
| <b>Loss before federal income taxes</b>  | <b>(52.0)</b>                      | <b>(0.2)</b> |
| Federal income tax expense (benefit)   | 6.7                                | (0.4)        |
| <b>Net (loss) income</b>   | <b>\$ (58.7)</b>                   | <b>0.2</b>   |
| (Loss) income per common share:  |                                    |              |
| Basic  | \$ (1.46)                          | 0.01         |
| Diluted  | \$ (1.46)                          | 0.00         |
| Dividends paid per common share  | \$ 0.15                            | 0.15         |

See accompanying notes to condensed consolidated financial statements.

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## 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<br>September 30 |                |
|--|-----------------------------------|----------------|
|  | 2011                              | 2010           |
| Earned premiums (ceded to affiliates \$606.6 and \$612.0, respectively)          | \$ 1,059.4                        | 929.9          |
| Net investment income (affiliate \$3.7 and \$3.7, respectively)                  | 66.5                              | 60.6           |
| Net realized gain on investments:  |                                   |                |
| Total other-than-temporary impairment losses                                     | (5.3)                             | (3.1)          |
| Portion of loss recognized in other comprehensive income                         |                                   |                |
| Other net realized investment gains  | 30.2                              | 9.4            |
| Total net realized gain on investments   | 24.9                              | 6.3            |
| Other income (affiliates \$1.8 and \$1.2, respectively)                          | 1.8                               | 1.4            |
| <b>Total revenues</b>  | <b>1,152.6</b>                    | <b>998.2</b>   |
| Losses and loss expenses (ceded to affiliates \$590.9 and \$439.9, respectively) | 959.5                             | 684.7          |
| Acquisition and operating expenses   | 355.6                             | 309.8          |
| Interest expense (affiliates \$0.5 and \$0.5, respectively)                      | 5.4                               | 5.3            |
| Other expenses   | 6.3                               | 8.0            |
| <b>Total expenses</b>  | <b>1,326.8</b>                    | <b>1,007.8</b> |
| <b>Loss before federal income taxes</b>  | <b>(174.2)</b>                    | <b>(9.6)</b>   |
| Federal income tax expense   | 73.2                              | 3.5            |
| <b>Net loss</b>  | <b>\$ (247.4)</b>                 | <b>(13.1)</b>  |
| Loss per common share:   |                                   |                |
| Basic  | \$ (6.15)                         | (0.33)         |
| Diluted  | \$ (6.15)                         | (0.33)         |
| Dividends paid per common share  | \$ 0.45                           | 0.45           |

See accompanying notes to condensed consolidated financial statements.

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## 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<br>September 30 |               |
|--|-----------------------------------|---------------|
| (unaudited)  | 2011                              | 2010          |
| <b>Cash flows from operating activities:</b>   |                                   |               |
| Net loss   | \$ (247.4)                        | (13.1)        |
| Adjustments to reconcile net loss to net cash provided by operating activities:              |                                   |               |
| Depreciation and amortization, net   | 2.9                               | 6.5           |
| Share-based compensation   | 2.2                               | 2.9           |
| Net realized gain on investments   | (24.9)                            | (6.3)         |
| Changes in operating assets and liabilities:   |                                   |               |
| Deferred policy acquisition costs  | (13.8)                            | (23.2)        |
| Accrued investment income and other assets   | (1.8)                             | 0.7           |
| Postretirement and pension benefits  | 2.8                               | 5.7           |
| Other liabilities and due to/from affiliates, net  | 13.0                              | 0.1           |
| Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums | (12.0)                            | (0.6)         |
| Losses and loss expenses payable   | 123.2                             | 55.2          |
| Unearned premiums  | 46.4                              | 77.5          |
| Excess tax benefits on share based awards  |                                   | 0.3           |
| Federal income taxes   | 74.7                              | (12.0)        |
| Cash provided from pooling change, January 1, 2011 and 2010 (Note 4)                         | 69.1                              | 3.7           |
| <b>Net cash provided by operating activities</b>   | <b>34.4</b>                       | <b>97.4</b>   |
| <b>Cash flows from investing activities:</b>   |                                   |               |
| Purchases of fixed maturities available-for-sale   | (338.5)                           | (326.8)       |
| Purchases of equity securities available-for-sale  | (88.1)                            | (78.2)        |
| Purchases of other invested assets   | (0.8)                             | (20.6)        |
| Maturities, calls and pay downs of fixed maturities available-for-sale                       | 246.2                             | 218.2         |
| Sales of fixed maturities available-for-sale   | 101.7                             | 70.2          |
| Sales of equity securities available-for-sale  | 136.0                             | 63.0          |
| Sales of other invested assets   | 10.7                              | 0.6           |
| Sale of subsidiary   | 13.2                              |               |
| <b>Net cash provided by (used in) investing activities</b>                                   | <b>80.4</b>                       | <b>(73.6)</b> |
| <b>Cash flows from financing activities:</b>   |                                   |               |
| Proceeds from issuance of common stock   | 1.6                               | 2.2           |
| Payment of dividends   | (18.0)                            | (18.0)        |
| <b>Net cash used in financing activities</b>   | <b>(16.4)</b>                     | <b>(15.8)</b> |

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|  |                 |      |
|--|-----------------|------|
| Net increase in cash and cash equivalents                | <b>98.4</b>     | 8.0  |
| Cash and cash equivalents at beginning of period         | <b>88.3</b>     | 90.3 |
| <b>Cash and cash equivalents at end of period</b>        | <b>\$ 186.7</b> | 98.3 |
| <u>Supplemental disclosures:</u>                         |                 |      |
| Interest paid (affiliates \$0.5 and \$0.5, respectively) | <b>\$ 3.7</b>   | 3.7  |
| Federal income taxes (received) paid                     | <b>\$ (1.5)</b> | 15.2 |

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries ( State Auto Financial or the Company ) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles ( GAAP ) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The balance sheet at December 31, 2010 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2010 (the 2010 Form 10-K ). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2010 Form 10-K.

*Adoption of Accounting Pronouncements*

*Improving Disclosures about Fair Value Measurements*

In January 2010, the Financial Accounting Standards Board ( FASB ) issued guidance to improve the disclosures related to fair value measurements. The guidance requires the information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements to be presented separately on a gross basis, rather than as one net number. The Company adopted this guidance effective January 1, 2011. The disclosures required by this guidance are provided in the accompanying Note 3.

*Pending Adoption of Accounting Pronouncements*

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

In October 2010, the FASB issued updated guidance to address diversity in practice for the accounting of costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. The new guidance is effective on a prospective basis for fiscal years beginning after December 15, 2011, with early adoption permitted. Retrospective application is also permitted, but not required. The Company is still assessing the impact the provisions of the new guidance will have on its consolidated financial statements.

*Comprehensive Income*

In June 2011, the FASB issued updated guidance to improve the presentation of comprehensive income. In this guidance an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Regardless of how an entity chooses to present comprehensive income, the entity is required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The new guidance is effective for fiscal years and interim periods beginning after December 15, 2011, with early adoption permitted. Retrospective application is required. The adoption of this new guidance is not expected to have a material impact on the consolidated

financial statements.

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

In May 2011, the FASB issued amendments to its Fair Value Measurement Topic that is expected to result in common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards (IFRS). Consequently, the amendments in the guidance change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendments in the guidance to result in a change in the application of the requirements in the Fair Value Measurements Topic. The guidance also clarifies the FASB's intent about the application of existing fair value measurement requirements as well as changes to a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The new guidance is effective on a prospective basis for fiscal years and interim

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

periods beginning after December 15, 2011. The adoption of this new guidance is not expected to have a material impact on the financial statements.

*Testing Goodwill for Impairment*

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

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**2. Investments**

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at September 30, 2011 and December 31, 2010:

(\$ millions)

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses | Fair<br>value  |
|--|------------------------------|---|--|----------------|
| <b>At September 30, 2011:</b>  |                              |   |  |                |
| Fixed maturities:  |                              |   |  |                |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 478.6                     | 30.1                                    | (0.1)                                    | 508.6          |
| Obligations of states and political subdivisions                     | 812.0                        | 44.9                                    |  | 856.9          |
| Corporate securities   | 240.5                        | 11.9                                    | (0.6)                                    | 251.8          |
| U.S. government agencies residential mortgage-backed securities      | 405.0                        | 19.5                                    | (0.7)                                    | 423.8          |
| <i>Total fixed maturities</i>  | <b>1,936.1</b>               | <b>106.4</b>                            | <b>(1.4)</b>                             | <b>2,041.1</b> |
| Equity securities:   |                              |   |  |                |
| Large-cap securities   | 138.6                        | 14.2                                    | (9.9)                                    | 142.9          |
| Small-cap securities   | 34.9                         | 4.6                                     |  | 39.5           |
| <i>Total equity securities</i>                                       | <b>173.5</b>                 | <b>18.8</b>                             | <b>(9.9)</b>                             | <b>182.4</b>   |
| Other invested assets  | 56.7                         | 8.6                                     |  | 65.3           |
| <i>Total available-for-sale securities</i>                           | <b>\$ 2,166.3</b>            | <b>133.8</b>                            | <b>(11.3)</b>                            | <b>2,288.8</b> |

(\$ millions)

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses | Fair<br>value  |
|--|------------------------------|---|--|----------------|
| <b>At December 31, 2010:</b>   |                              |   |  |                |
| Fixed maturities:  |                              |   |  |                |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 450.5                     | 12.9                                    | (2.3)                                    | 461.1          |
| Obligations of states and political subdivisions                     | 916.6                        | 23.6                                    | (6.6)                                    | 933.6          |
| Corporate securities   | 136.3                        | 6.2                                     | (0.1)                                    | 142.4          |
| U.S. government agencies residential mortgage-backed securities      | 358.9                        | 8.4                                     | (3.7)                                    | 363.6          |
| <i>Total fixed maturities</i>  | <b>1,862.3</b>               | <b>51.1</b>                             | <b>(12.7)</b>                            | <b>1,900.7</b> |
| Equity securities:   |                              |   |  |                |
| Large-cap securities   | 167.1                        | 45.5                                    | (1.5)                                    | 211.1          |

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|  |            |       |        |         |
|--|------------|-------|--------|---------|
| Small-cap securities                       | 33.1       | 12.0  |        | 45.1    |
| <i>Total equity securities</i>             | 200.2      | 57.5  | (1.5)  | 256.2   |
| Other invested assets                      | 64.4       | 15.3  |        | 79.7    |
| <i>Total available-for-sale securities</i> | \$ 2,126.9 | 123.9 | (14.2) | 2,236.6 |

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's gross unrealized losses and fair value on its investments by lot, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at September 30, 2011 and December 31, 2010:

(\$ millions, except # of positions)

|  | Less than 12 months |                   |                     | 12 months or more |                   |                     | Total           |                   |                     |
|--|---------------------|-------------------|---------------------|-------------------|-------------------|---------------------|-----------------|-------------------|---------------------|
|  | Fair value          | Unrealized losses | Number of positions | Fair value        | Unrealized losses | Number of positions | Fair value      | Unrealized losses | Number of positions |
| <b>At September 30, 2011:</b>  |                     |                   |                     |                   |                   |                     |                 |                   |                     |
| <b>Fixed maturities:</b>   |                     |                   |                     |                   |                   |                     |                 |                   |                     |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 12.0             | \$ (0.1)          | 4                   | \$                | \$                |                     | \$ 12.0         | \$ (0.1)          | 4                   |
| Obligations of states and political subdivisions                     | 5.5                 |                   | 3                   |                   |                   |                     | 5.5             |                   | 3                   |
| Corporate securities   | 50.4                | (0.6)             | 14                  |                   |                   |                     | 50.4            | (0.6)             | 14                  |
| U.S. government agencies residential mortgage-backed securities      | 34.5                | (0.2)             | 10                  | 15.3              | (0.5)             | 7                   | 49.8            | (0.7)             | 17                  |
| <i>Total fixed maturities</i>  | <b>102.4</b>        | <b>(0.9)</b>      | <b>31</b>           | <b>15.3</b>       | <b>(0.5)</b>      | <b>7</b>            | <b>117.7</b>    | <b>(1.4)</b>      | <b>38</b>           |
| Large-cap equity securities:   | 51.6                | (9.3)             | 22                  | 5.9               | (0.6)             | 2                   | 57.5            | (9.9)             | 24                  |
| Other invested assets:   | 4.4                 |                   | 1                   |                   |                   |                     | 4.4             |                   | 1                   |
| <i>Total temporarily impaired securities</i>                         | <b>\$ 158.4</b>     | <b>\$ (10.2)</b>  | <b>54</b>           | <b>\$ 21.2</b>    | <b>\$ (1.1)</b>   | <b>9</b>            | <b>\$ 179.6</b> | <b>\$ (11.3)</b>  | <b>63</b>           |

(\$ millions, except # of positions)

|  | Less than 12 months |                   |                     | 12 months or more |                   |                     | Total        |                   |                     |
|--|---------------------|-------------------|---------------------|-------------------|-------------------|---------------------|--------------|-------------------|---------------------|
|  | Fair value          | Unrealized losses | Number of positions | Fair value        | Unrealized losses | Number of positions | Fair value   | Unrealized losses | Number of positions |
| <b>At December 31, 2010:</b>   |                     |                   |                     |                   |                   |                     |              |                   |                     |
| <b>Fixed maturities:</b>   |                     |                   |                     |                   |                   |                     |              |                   |                     |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 102.0            | \$ (2.3)          | 25                  | \$                | \$                |                     | \$ 102.0     | \$ (2.3)          | 25                  |
| Obligations of states and political subdivisions                     | 239.0               | (6.6)             | 92                  |                   |                   |                     | 239.0        | (6.6)             | 92                  |
| Corporate securities   | 12.6                | (0.1)             | 5                   |                   |                   |                     | 12.6         | (0.1)             | 5                   |
| U.S. government agencies residential mortgage-backed securities      | 116.6               | (3.0)             | 26                  | 20.3              | (0.7)             | 9                   | 136.9        | (3.7)             | 35                  |
| <i>Total fixed maturities</i>  | <b>470.2</b>        | <b>(12.0)</b>     | <b>148</b>          | <b>20.3</b>       | <b>(0.7)</b>      | <b>9</b>            | <b>490.5</b> | <b>(12.7)</b>     | <b>157</b>          |
| Large-cap equity securities:   | 14.8                | (1.4)             | 6                   | 2.2               | (0.1)             | 1                   | 17.0         | (1.5)             | 7                   |

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|  |          |           |     |         |          |    |          |           |     |
|--|----------|-----------|-----|---------|----------|----|----------|-----------|-----|
| <i>Total temporarily impaired securities</i> | \$ 485.0 | \$ (13.4) | 154 | \$ 22.5 | \$ (0.8) | 10 | \$ 507.5 | \$ (14.2) | 164 |
|--|----------|-----------|-----|---------|----------|----|----------|-----------|-----|

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the realized losses related to other-than-temporary impairments on the Company's investment portfolio recognized for the three and nine months ended September 30, 2011 and 2010:

| <i>(\$ millions)</i>                          | Three months ended<br>September 30 |       | Nine months ended<br>September 30 |       |
|---|------------------------------------|-------|-----------------------------------|-------|
|   | <b>2011</b>                        | 2010  | <b>2011</b>                       | 2010  |
| Equity securities:                            |                                    |       |                                   |       |
| Large-cap securities                          | \$ (0.2)                           |       | \$ (0.2)                          | (0.3) |
| Small-cap securities                          | (4.2)                              | (0.6) | (5.1)                             | (2.8) |
| <i>Total other-than-temporary impairments</i> | <b>\$ (4.4)</b>                    | (0.6) | <b>\$ (5.3)</b>                   | (3.1) |

The Company did not recognize other-than-temporary impairments on its fixed maturity securities for the three and nine months ended September 30, 2011 and 2010. The Company reviewed its investments at September 30, 2011, and determined no additional other-than-temporary impairment existed in the gross unrealized holding losses.

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

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

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at September 30, 2011:

| <i>(\$ millions)</i> | Amortized<br>cost | Fair<br>value |
|----------------------|-------------------|---------------|
|----------------------|-------------------|---------------|

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|   |                |             |
|---|----------------|-------------|
| Due in 1 year or less   | \$ 49.0        | 49.2        |
| Due after 1 year through 5 years                                | 378.1          | 393.1       |
| Due after 5 years through 10 years                              | 542.8          | 579.9       |
| Due after 10 years  | 561.2          | 595.1       |
| U.S. government agencies residential mortgage-backed securities | 405.0          | 423.8       |
| <br><i>Total</i>  | <br>\$ 1,936.1 | <br>2,041.1 |

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.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Fixed maturities with fair values of \$79.7 million and \$72.2 million were on deposit with insurance regulators as required by law at September 30, 2011 and December 31, 2010, respectively.

The following table sets forth the components of net investment income for the three and nine months ended September 30, 2011 and 2010:

| (\$ millions)                        | Three months ended   |      | Nine months ended    |      |
|--------------------------------------|----------------------|------|----------------------|------|
|                                      | September 30<br>2011 | 2010 | September 30<br>2011 | 2010 |
| Fixed maturities                     | \$ 18.4              | 17.1 | \$ 60.2              | 54.1 |
| Equity securities                    | 1.1                  | 1.4  | 3.8                  | 4.0  |
| Cash and cash equivalents, and other | 1.4                  | 1.4  | 4.2                  | 4.1  |
| <i>Investment income</i>             | <b>20.9</b>          | 19.9 | <b>68.2</b>          | 62.2 |
| Investment expenses                  | 0.6                  | 0.6  | 1.7                  | 1.6  |
| <i>Net investment income</i>         | <b>\$ 20.3</b>       | 19.3 | <b>\$ 66.5</b>       | 60.6 |

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

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three and nine months ended September 30, 2011 and 2010:

| (\$ millions)  | Three months ended |        | Nine months ended |        |
|--|--------------------|--------|-------------------|--------|
|  | September 30       |        | September 30      |        |
|  | 2011               | 2010   | 2011              | 2010   |
| <b>Realized gains:</b>   |                    |        |                   |        |
| Fixed maturities   | \$ 1.1             | 0.6    | \$ 2.9            | 1.8    |
| Equity securities  | 13.7               | 3.4    | 31.4              | 10.7   |
| Other invested assets  | 2.1                |        | 2.1               |        |
| <i>Total realized gains</i>  | <b>16.9</b>        | 4.0    | <b>36.4</b>       | 12.5   |
| <b>Realized losses:</b>  |                    |        |                   |        |
| Equity securities:   |                    |        |                   |        |
| Sales  | (2.3)              | (0.6)  | (5.3)             | (3.1)  |
| OTTI   | (4.4)              | (0.6)  | (5.3)             | (3.1)  |
| <i>Total realized losses</i>                                       | <b>(6.7)</b>       | (1.2)  | <b>(10.6)</b>     | (6.2)  |
| <i>Net realized gain on investments</i>                            | <b>\$ 10.2</b>     | 2.8    | <b>\$ 25.8</b>    | 6.3    |
| <b>Change in unrealized holding gains (losses), net of tax:</b>    |                    |        |                   |        |
| Fixed maturities   | \$ 42.6            | 25.2   | \$ 66.6           | 49.9   |
| Equity securities  | (46.3)             | 22.1   | (47.1)            | 2.3    |
| Other invested assets  | (12.3)             | 9.0    | (6.7)             | 3.7    |
| Deferred federal income tax asset (liability) thereon              | 5.6                | (19.6) | (4.5)             | (19.5) |
| <i>Change in net unrealized holding gains (losses), net of tax</i> | <b>\$ (10.4)</b>   | 36.7   | <b>\$ 8.3</b>     | 36.4   |

There was a deferred federal income tax liability on the net unrealized holding gains at September 30, 2011 and December 31, 2010, of \$42.9 million and \$38.4 million, respectively. The unrealized holding gains and losses, net of applicable deferred federal income taxes, are shown as a separate component of stockholders' equity as a part of accumulated other comprehensive income (loss) and, as such, are not included in the determination of net income. Realized gains and losses on the sales of investments are computed using the first-in, first-out method.

**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:

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

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

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

The Company utilizes one nationally recognized pricing service to estimate the majority of its available for sale investment portfolio's fair value. The Company obtains one price per security and the processes and control procedures employed by the Company are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company gains an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, the Company compares to other fair value pricing information gathered from other

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

independent pricing sources. At September 30, 2011 and December 31, 2010, the Company did not adjust any of the prices received from the pricing service.

Transfers between level categorizations may occur due to changes in the availability of market observable inputs. Transfers in and out of level categorizations are reported as having occurred at the beginning of the quarter in which the transfer occurred. There were no transfers between level categorizations during the three and nine months ended September 30, 2011 and 2010.

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 the majority of its fixed maturities. The fair value estimate of the Company's fixed maturity investments are determined by evaluations that are based on observable market information rather than market quotes. Inputs to the evaluations include, but are not limited to, market prices from recently completed transactions and transactions of comparable securities, interest rate yield curves, credit spreads, and other market-observable information. Investments valued using these inputs include U.S. treasury securities and obligations of U.S. government agencies, obligations of states and political subdivisions, corporate securities (except for one security discussed below), and U.S. government agencies residential mortgage-backed securities. All unadjusted estimates of fair value for fixed maturities priced by the pricing service are included in the amounts disclosed in Level 2 of the hierarchy. If market inputs are unavailable, then no fair value is provided by the pricing service. For these securities, fair value is determined either by requesting brokers who are knowledgeable about these securities to provide a quote; or the Company internally determines the fair values by employing widely accepted pricing valuation models, and depending on the level of observable market inputs, renders the fair value estimate as Level 2 or Level 3. The Company holds one fixed maturity corporate security for which the Company estimates the fair value of this security using the present value of the future cash flows. Due to the limited amount of observable market information, the Company includes the fair value estimates for this security in Level 3.

*Equities*

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

*Other Invested Assets*

Included in other invested assets are two international private equity funds (the funds) that invest in equity securities of foreign issuers and are managed by third party investment managers. The funds had a fair value of \$60.9 million and \$75.3 million at September 30, 2011 and December 31, 2010, respectively, which was determined using each fund's net asset value. The Company employs procedures to assess the reasonableness of the fair value of the funds including obtaining and reviewing each fund's audited financial statements. There are no unfunded commitments related to the funds. The Company may not sell its investment in the funds; however, the Company may redeem all or a portion of its investment in the funds at net asset value per share with the appropriate prior written notice. Due to the Company's ability to redeem its investment in the funds at net asset value per share at the measurement date, the funds have been disclosed in Level 2.

The remainder of the Company's other invested assets consist primarily of holdings in publicly-traded mutual funds. The Company believes that its prices for these publicly-traded mutual funds based on an observable market price for an identical asset in an active market reflect their fair

values and consequently these securities have been disclosed in Level 1.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's available-for-sale investments within the fair value hierarchy at September 30, 2011 and December 31, 2010:

(\$ millions)

|  | Total             | Quoted prices<br>in active<br>markets for<br>identical<br>assets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
|--|-------------------|---|---|--|
| <b>At September 30, 2011:</b>  |                   |   |   |  |
| Fixed maturities:  |                   |   |   |  |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 508.6          |   | 508.6   |  |
| Obligations of states and political subdivisions                     | 856.9             |   | 856.9   |  |
| Corporate securities   | 251.8             |   | 249.0   | 2.8  |
| U.S. government agencies residential mortgage-backed securities      | 423.8             |   | 423.8   |  |
| <i>Total fixed maturities</i>  | <b>2,041.1</b>    |   | <b>2,038.3</b>  | <b>2.8</b>   |
| Equity securities:   |                   |   |   |  |
| Large-cap securities   | 142.9             | 142.9   |   |  |
| Small-cap securities   | 39.5              | 39.5  |   |  |
| <i>Total equity securities</i>                                       | <b>182.4</b>      | <b>182.4</b>  |   |  |
| Other invested assets  | 65.3              | 4.4   | 60.9  |  |
| <i>Total available-for-sale investments</i>                          | <b>\$ 2,288.8</b> | <b>186.8</b>  | <b>2,099.2</b>  | <b>2.8</b>   |

(\$ millions)

|  | Total    | Quoted prices<br>in active<br>markets for<br>identical<br>assets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
|--|----------|---|---|--|
| <b>At December 31, 2010:</b>   |          |   |   |  |
| Fixed maturities:  |          |   |   |  |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 461.1 |   | 461.1   |  |

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|   |            |       |         |     |
|---|------------|-------|---------|-----|
| Obligations of states and political subdivisions                | 933.6      |       | 933.6   |     |
| Corporate securities  | 142.4      |       | 139.7   | 2.7 |
| U.S. government agencies residential mortgage-backed securities | 363.6      |       | 363.6   |     |
| <i>Total fixed maturities</i>                                   | 1,900.7    |       | 1,898.0 | 2.7 |
| Equity securities:  |            |       |         |     |
| Large-cap securities  | 211.1      | 211.1 |         |     |
| Small-cap securities  | 45.1       | 45.1  |         |     |
| <i>Total equity securities</i>                                  | 256.2      | 256.2 |         |     |
| Other invested assets   | 79.7       | 4.4   | 75.3    |     |
| <i>Total available-for-sale investments</i>                     | \$ 2,236.6 | 260.6 | 1,973.3 | 2.7 |

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), the following tables set forth a reconciliation of the beginning and ending balances for the three and nine months ended September 30, 2011 and the year ended December 31, 2010, separately for each major category of assets:

|  |                     |
|--|---------------------|
| <i>(\$ millions)</i>   | Fixed<br>maturities |
| Balance at January 1, 2011   | \$ 2.7              |
| Total realized gains (losses) included in earnings                     |                     |
| Total unrealized gains (losses) included in other comprehensive income |                     |
| Purchases  | 0.2                 |
| Sales  | (0.1)               |
| Transfers into Level 3   |                     |
| Transfers out of Level 3   |                     |
| Balance at March 31, 2011  | 2.8                 |
| Total realized gains (losses) included in earnings                     |                     |
| Total unrealized gains (losses) included in other comprehensive income |                     |
| Purchases  | 0.1                 |
| Sales  | (0.3)               |
| Transfers into Level 3   |                     |
| Transfers out of Level 3   |                     |
| Balance at June 30, 2011   | \$ 2.6              |
| Total realized gains (losses) included in earnings                     |                     |
| Total unrealized gains (losses) included in other comprehensive income |                     |
| Purchases  | 0.2                 |
| Sales  |                     |
| Transfers into Level 3   |                     |
| Transfers out of Level 3   |                     |
| Balance at September 30, 2011  | \$ 2.8              |
| <i>(\$ millions)</i>   | Fixed<br>maturities |
| Balance at January 1, 2010   | \$ 2.3              |
| Total realized gains (losses) included in earnings                     |                     |
| Total unrealized gains (losses) included in other comprehensive income |                     |
| Purchases, issuances, and settlements                                  | 0.4                 |
| Transfers in and/or out of Level 3                                     |                     |

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Balance at December 31, 2010

\$ 2.7

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the carrying value and fair value of financial instruments at September 30, 2011:

| <i>(\$ millions)</i>                                     | Carrying<br>value | Fair<br>value     | Reference  |
|--|-------------------|-------------------|------------|
| <b>Assets:</b>   |                   |                   |            |
| Fixed maturities, available-for-sale, at fair value      | <b>\$ 2,041.1</b> | <b>\$ 2,041.1</b> | See above  |
| Equity securities, available-for-sale, at fair value     | <b>182.4</b>      | <b>182.4</b>      | See above  |
| Other invested assets, available-for-sale, at fair value | <b>65.3</b>       | <b>65.3</b>       | See above  |
| Notes receivable from affiliate                          | <b>70.0</b>       | <b>78.3</b>       | See Note 5 |
| <b>Liabilities:</b>                                      |                   |                   |            |
| Notes payable  | <b>116.5</b>      | <b>122.6</b>      | See Note 6 |

**4. Reinsurance**

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

In conjunction with the January 1, 2010 Pooling Arrangement amendment, which added to the pool State Auto National Insurance Company ( SA National ) and voluntary assumed reinsurance from third parties unaffiliated with the pool participants that was assumed on or after January 1, 2009, the STFC Pooled Companies received \$3.7 million in cash from the Mutual Pooled Companies for net insurance assets transferred on January 1, 2010. State Auto Financial sold SA National to a third party on December 31, 2010. SA National 's participation in the Pooling Arrangement was terminated on its sale.

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

| <i>(\$ millions)</i>             |          |
|----------------------------------|----------|
| Losses and loss expenses payable | \$ 124.5 |
| Unearned premiums                | 34.1     |
| Other liabilities                | (0.5)    |

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Less:

|                            |     |
|----------------------------|-----|
| Deferred acquisition costs | 8.3 |
|----------------------------|-----|

|   |          |
|---|----------|
| <i>Net cash and/or investment securities received</i> | \$ 149.8 |
|---|----------|

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth a summary of the Company's external reinsurance transactions, as well as reinsurance transactions with State Auto Mutual under the Pooling Arrangement, for the three and nine months ended September 30, 2011 and 2010:

| (\$ millions)  | Three months ended<br>September 30 |         | Nine months ended<br>September 30 |         |
|--|------------------------------------|---------|-----------------------------------|---------|
|  | 2011                               | 2010    | 2011                              | 2010    |
| <b>Premiums earned:</b>                              |                                    |         |                                   |         |
| Assumed from external insurers and reinsurers        | \$ 2.6                             | 0.6     | \$ 16.7                           | 2.6     |
| Assumed under Pooling Arrangement                    | 356.8                              | 317.9   | 1,059.4                           | 929.9   |
| Ceded to external insurers and reinsurers            | (7.0)                              | (7.1)   | (19.3)                            | (20.4)  |
| Ceded under Pooling Arrangement                      | (198.7)                            | (205.7) | (606.6)                           | (612.0) |
| <i>Net assumed premiums earned</i>                   | \$ 153.7                           | 105.7   | \$ 450.2                          | 300.1   |
| <b>Losses and loss expenses incurred:</b>            |                                    |         |                                   |         |
| Assumed from external insurers and reinsurers        | \$ 2.3                             | 0.7     | \$ 11.5                           | 1.7     |
| Assumed under Pooling Arrangement                    | 314.4                              | 230.8   | 956.8                             | 679.8   |
| Ceded to external insurers and reinsurers            | (10.4)                             | (5.1)   | (23.4)                            | (4.1)   |
| Ceded under Pooling Arrangement                      | (182.0)                            | (146.3) | (590.9)                           | (439.9) |
| <i>Net assumed losses and loss expenses incurred</i> | \$ 124.3                           | 80.1    | \$ 354.0                          | 237.5   |

**5. Transactions with Affiliates**

In May 2009, the Company entered into two separate credit agreements with State Auto Mutual pursuant to which it loaned State Auto Mutual a total of \$70.0 million. Under these agreements, State Auto Financial earned interest of \$1.3 million and \$3.7 million for the three and nine months ended September 30, 2011 and 2010. 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. The following table sets forth the notes receivable at September 30, 2011 and December 31, 2010:

| (\$ millions, except interest rates) | September 30, 2011 |            |               | December 31, 2010 |            |               |
|--------------------------------------|--------------------|------------|---------------|-------------------|------------|---------------|
|                                      | Carrying value     | Fair value | Interest rate | Carrying value    | Fair value | Interest rate |
| Notes receivable from affiliate      | \$ 70.0            | \$ 78.3    | 7.00%         | \$ 70.0           | \$ 71.1    | 7.00%         |



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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**6. Notes Payable**

The fair value of the Senior Notes is based on the quoted market price at September 30, 2011 and December 31, 2010, respectively. The carrying amount of the Affiliate Subordinated Debentures approximates its fair value as the interest rate adjusts quarterly. The following table sets forth the notes payable at September 30, 2011 and December 31, 2010:

(\$ millions, except interest rates)

|  | September 30, 2011 |                 |               | December 31, 2010 |            |               |
|--|--------------------|-----------------|---------------|-------------------|------------|---------------|
|  | Carrying Value     | Fair value      | Interest rate | Carrying value    | Fair value | Interest rate |
| Senior Notes due 2013: issued \$100.0, November 2003 with fixed interest                   | \$ 101.0           | \$ 107.1        | 6.25%         | \$ 101.3          | \$ 106.4   | 6.25%         |
| Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest | 15.5               | 15.5            | 4.45          | 15.5              | 15.5       | 4.50          |
| <i>Total notes payable</i>   | <b>\$ 116.5</b>    | <b>\$ 122.6</b> |               | \$ 116.8          | \$ 121.9   |               |

On September 29, 2011, the Company terminated its then-current credit agreement and entered into a new credit facility ( Credit Facility ) with a syndicate of lenders which provides for a \$100.0 million five-year unsecured revolving credit facility maturing in September 2016. During the term of the Credit Facility, the Company has the right to increase the total facility to a maximum total facility amount of \$150.0 million, provided that no event of default has occurred and is continuing. The Credit Facility is available for general corporate purposes and provides for interest-only payments during its term, with principal and interest due in full at maturity. Interest is based on a LIBOR 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, 2011, the Company had not made any borrowings and was in compliance with all of its covenants.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**7. Income Taxes**

The following table sets forth the reconciliation between actual federal income tax expense (benefit) and the amount computed at the indicated statutory rate for the three and nine months ended September 30, 2011 and 2010:

| (\$ millions)   | Three months ended<br>September 30 |      |          |       | Nine months ended<br>September 30 |      |          |       |
|---|------------------------------------|------|----------|-------|-----------------------------------|------|----------|-------|
|   | 2011                               | %    | 2010     | %     | 2011                              | %    | 2010     | %     |
| Amount at statutory rate  | \$ (18.2)                          | 35   | \$ (0.1) | 35    | \$ (61.0)                         | 35   | \$ (3.4) | 35    |
| Tax-exempt interest and dividends received deduction                            | (2.7)                              | 5    | (3.2)    | 195   | (8.4)                             | 5    | (9.9)    | 104   |
| Patient Protection and Affordable Care Act, Medicare<br>Part D exemption repeal |                                    |      |          |       |                                   |      | 4.5      | (48)  |
| Other, net  | (1.3)                              | 3    | 2.9      | (455) | (1.2)                             | 1    | 12.3     | (128) |
| Valuation allowance   | 28.9                               | (55) |          |       | 143.8                             | (83) |          |       |
| <i>Federal income tax expense (benefit) and effective rate</i>                  | \$ 6.7                             | (12) | \$ (0.4) | 225   | \$ 73.2                           | (42) | \$ 3.5   | (37)  |

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities at September 30, 2011 and December 31, 2010:

| <i>(\$ millions)</i>                             | <b>September 30,<br/>2011</b> | December 31,<br>2010 |
|--|-------------------------------|----------------------|
| Deferred tax assets:                             |                               |                      |
| Unearned premiums not currently deductible       | \$ 48.1                       | 42.6                 |
| Losses and loss expenses payable discounting     | 32.1                          | 25.2                 |
| Postretirement and pension benefits              | 62.8                          | 63.1                 |
| Realized loss on other-than-temporary impairment | 12.4                          | 11.0                 |
| Compensation and benefits                        | 14.0                          | 16.9                 |
| Asset valuation allowance                        | 1.5                           | 3.8                  |
| Net operating loss carryforward                  | 72.9                          | 4.0                  |
| AMT credit carryforward                          | 1.2                           | 7.7                  |
| Other  | 2.5                           | 2.9                  |
| <i>Total deferred tax assets</i>                 | <b>247.5</b>                  | 177.2                |
| Deferred tax liabilities:                        |                               |                      |
| Deferral of policy acquisition costs             | 60.3                          | 52.5                 |
| Unrealized holding gains on investments          | 42.9                          | 38.4                 |
| <i>Total deferred tax liabilities</i>            | <b>103.2</b>                  | 90.9                 |
| <i>Total net deferred tax assets</i>             | <b>144.3</b>                  | 86.3                 |
| Less valuation allowance                         | <b>143.8</b>                  |                      |
| <i>Net deferred federal income taxes</i>         | <b>\$ 0.5</b>                 | 86.3                 |

Deferred income tax assets and liabilities represent the tax effect of the differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. The Company periodically evaluates its deferred tax assets, which requires significant judgment, to determine if they are realizable based upon weighing all available evidence, both positive and negative, including loss carryback potential, past operating results, existence of cumulative losses in the most recent years, projected performance of the business, future taxable income, including the ability to generate capital gains, and prudent and feasible tax planning strategies. In making such judgments, significant weight is given to evidence that can be objectively verified. If, based on available information, it is more likely than not that the deferred income tax asset will not be realized, then a valuation allowance must be established with a corresponding charge to net income and/or accumulated other comprehensive income (loss). At September 30, 2011, the Company's net deferred tax asset notwithstanding the valuation allowance totaled \$144.3 million, compared to \$86.3 million at December 31, 2010. The increase in the September 30, 2011 balance primarily related to the net operating loss carry-forward reflecting the impact of storm losses for the nine months ended September 30, 2011. The magnitude of the second quarter catastrophe losses from unprecedented storms experienced industry wide, which by far exceeded the Company's projections,

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resulted in an expectation that the Company will report a pre-tax loss in 2011 and have a taxable loss for the year. The Company considered both positive and negative evidence and concluded a valuation allowance of \$115.0 million should be established at June 30, 2011. The valuation allowance increased to \$143.8 million at September 30, 2011. Included in total tax expense for the three and nine months ended September 30, 2011 is \$28.9 million and \$143.8 million, respectively related to changes in the valuation allowance. The \$0.5 million of deferred income tax asset remaining after recognition of the valuation allowance represents a deferred tax asset on the gross unrealized fixed maturity losses where management determined this portion of the asset to be realizable due to management's assertion that it has both the ability and intent to hold these securities through recovery or maturity.

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**8. Pension and Postretirement Benefit Plans**

The following table sets forth the components of net periodic cost for the State Auto Group's pension and postretirement benefit plans for the three and nine months ended September 30, 2011 and 2010:

| (\$ millions)                  | Pension                         |       | Postretirement |       | Pension                        |        | Postretirement |       |
|--------------------------------|---------------------------------|-------|----------------|-------|--------------------------------|--------|----------------|-------|
|                                | Three months ended September 30 |       | September 30   |       | Nine months ended September 30 |        | September 30   |       |
|                                | 2011                            | 2010  | 2011           | 2010  | 2011                           | 2010   | 2011           | 2010  |
| Service cost                   | \$ 2.6                          | 2.7   | \$ 1.6         | 1.1   | \$ 7.9                         | 8.0    | \$ 4.7         | 3.4   |
| Interest cost                  | 3.8                             | 3.8   | 1.6            | 1.4   | 11.4                           | 11.2   | 4.8            | 4.2   |
| Expected return on plan assets | (4.6)                           | (4.3) | (0.1)          | (0.1) | (13.7)                         | (13.1) | (0.2)          | (0.2) |
| Curtailment gain               |                                 |       |                |       |                                |        |                | (1.1) |
| Amortization of:               |                                 |       |                |       |                                |        |                |       |
| Prior service costs (benefits) | 0.1                             | 0.1   | (0.4)          | (0.5) | 0.3                            | 0.3    | (1.2)          | (1.3) |
| Transition assets              | (0.1)                           | (0.2) |                |       | (0.3)                          | (0.6)  |                |       |
| Net loss                       | 1.8                             | 1.9   |                |       | 5.2                            | 4.9    |                |       |
| <i>Net periodic cost</i>       | <b>\$ 3.6</b>                   | 4.0   | <b>\$ 2.7</b>  | 1.9   | <b>\$ 10.8</b>                 | 10.7   | <b>\$ 8.1</b>  | 5.0   |

The Company contributed \$15.0 million to the pension plan in 2011.

**9. Net (Loss) Earnings per Common Share**

The following table sets forth the compilation of basic and diluted net (loss) earnings per common share for the three and nine months ended September 30, 2011 and 2010:

| (\$ millions, except per share amounts)                     | Three months ended |      | Nine months ended |        |
|---|--------------------|------|-------------------|--------|
|   | September 30       |      | September 30      |        |
|   | 2011               | 2010 | 2011              | 2010   |
| <b>Numerator:</b>   |                    |      |                   |        |
| Net (loss) earnings for basic net earnings per common share | \$ (58.7)          | 0.2  | \$ (247.4)        | (13.1) |
| <b>Denominator:</b>   |                    |      |                   |        |
| Basic weighted average shares outstanding                   | 40.3               | 40.0 | 40.2              | 39.9   |
| Effect of dilutive share-based awards                       |                    | 0.1  |                   |        |
| <i>Diluted weighted average shares outstanding</i>          | <b>40.3</b>        | 40.1 | <b>40.2</b>       | 39.9   |

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|   |           |      |           |        |
|---|-----------|------|-----------|--------|
| Basic net ( loss) earnings per common share | \$ (1.46) | 0.01 | \$ (6.15) | (0.33) |
| Diluted net loss per common share           | \$ (1.46) |      | \$ (6.15) | (0.33) |

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The following table sets forth the options to purchase shares of common stock that were not included in the computation of diluted earnings per common share because the exercise price of the options was greater than the average market price or their inclusion would have been antidilutive for the three and nine months ended September 30, 2011 and 2010:

| <i>(number of options in millions)</i> | Three months ended |      | Nine months ended |      |
|--|--------------------|------|-------------------|------|
|  | September 30       |      | September 30      |      |
|  | 2011               | 2010 | 2011              | 2010 |
| Number of options                      | 3.3                | 3.3  | 3.3               | 2.5  |

**10. Comprehensive (Loss) Income**

The following table sets forth the components of comprehensive (loss) income, net of related tax, for the three and nine months ended September 30, 2011 and 2010:

| <i>(\$ millions)</i>  | Three months ended |      | Nine months ended |        |
|---|--------------------|------|-------------------|--------|
|   | September 30       |      | September 30      |        |
|   | 2011               | 2010 | 2011              | 2010   |
| Net (loss) income   | \$ (58.7)          | 0.2  | \$ (247.4)        | (13.1) |
| Other comprehensive (loss) income:                          |                    |      |                   |        |
| Change in unrealized holding losses (gains), net of tax     | (10.4)             | 36.7 | 8.3               | 36.4   |
| Amortization of gain on derivative used in cash flow hedge  |                    |      | (0.1)             | (0.1)  |
| Change in unrecognized benefit plan obligations, net of tax | 0.8                | 0.9  | 2.7               | (12.1) |
| <i>Total other comprehensive (loss) income</i>              | <b>(9.6)</b>       | 37.6 | <b>10.9</b>       | 24.2   |
| <i>Comprehensive (loss) income</i>                          | <b>\$ (68.3)</b>   | 37.8 | <b>\$ (236.5)</b> | 11.1   |

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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**11. Segment Information**

Effective January 1, 2011, the Company had four reportable segments: personal insurance, business insurance, specialty insurance and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments market a broad line of property and casualty insurance products in all 50 states and the District of Columbia exclusively through independent insurance agencies and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages, including workers' compensation for both legacy State Auto Group and RTW, Inc.'s insurance subsidiaries, that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. The investment operations segment, managed by Stateco, provides investment services.

Due to internal changes which occurred in 2010, that included realigning the internal organization to be more strategic in the personal, business and specialty insurance markets, along with changes to the Pooling Arrangement as of January 1, 2011 (see Note 4), the Company changed its reportable insurance segments from personal and business insurance to the new segments described above. No changes were made to the investment operations segment. Prior reporting periods have been restated to conform to the new insurance segment presentation.

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

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

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth financial information regarding the Company's reportable segments for the three and nine months ended September 30, 2011 and 2010:

| <i>(\$ millions)</i>                           | Three months ended<br>September 30 |        | Nine months ended<br>September 30 |         |
|--|------------------------------------|--------|-----------------------------------|---------|
|  | <b>2011</b>                        | 2010   | <b>2011</b>                       | 2010    |
| <b>Revenues from external sources:</b>         |                                    |        |                                   |         |
| <b>Insurance segments</b>                      |                                    |        |                                   |         |
| Personal insurance                             | <b>\$ 198.5</b>                    | 201.7  | <b>\$ 604.0</b>                   | 594.7   |
| Business insurance                             | <b>94.3</b>                        | 95.3   | <b>283.8</b>                      | 287.9   |
| Specialty insurance                            | <b>64.0</b>                        | 21.0   | <b>171.6</b>                      | 47.3    |
| <i>Total insurance segments</i>                | <b>356.8</b>                       | 318.0  | <b>1,059.4</b>                    | 929.9   |
| <b>Investment operations segment</b>           |                                    |        |                                   |         |
| Net investment income                          | <b>20.3</b>                        | 19.3   | <b>66.5</b>                       | 60.6    |
| Net realized capital gains                     | <b>10.2</b>                        | 2.8    | <b>25.8</b>                       | 6.3     |
| <i>Total investment operations segment</i>     | <b>30.5</b>                        | 22.1   | <b>92.3</b>                       | 66.9    |
| All other                                      | <b>0.7</b>                         | 0.3    | <b>0.9</b>                        | 1.4     |
| <i>Total revenues from external sources</i>    | <b>388.0</b>                       | 340.4  | <b>1,152.6</b>                    | 998.2   |
| Intersegment revenues:                         | <b>2.6</b>                         | 2.5    | <b>7.8</b>                        | 7.3     |
| <i>Total revenues</i>                          | <b>390.6</b>                       | 342.9  | <b>1,160.4</b>                    | 1,005.5 |
| <b>Reconciling items:</b>                      |                                    |        |                                   |         |
| GAAP premium adjustment                        |                                    | 0.3    |                                   |         |
| Eliminate intersegment revenues                | <b>(2.6)</b>                       | (2.5)  | <b>(7.8)</b>                      | (7.3)   |
| <i>Total consolidated revenues</i>             | <b>\$ 388.0</b>                    | 340.7  | <b>\$ 1,152.6</b>                 | 998.2   |
| <b>Segment loss before federal income tax:</b> |                                    |        |                                   |         |
| <b>Insurance segments</b>                      |                                    |        |                                   |         |
| Personal insurance SAP underwriting loss       | <b>\$ (33.7)</b>                   | (0.5)  | <b>\$ (133.0)</b>                 | (23.2)  |
| Business insurance SAP underwriting loss       | <b>(30.7)</b>                      | (16.1) | <b>(87.7)</b>                     | (32.1)  |
| Specialty insurance SAP underwriting loss      | <b>(17.1)</b>                      | (8.0)  | <b>(49.3)</b>                     | (19.6)  |
| <i>Total insurance segments</i>                | <b>(81.5)</b>                      | (24.6) | <b>(270.0)</b>                    | (74.9)  |
| <b>Investment operations segment</b>           |                                    |        |                                   |         |
| Net investment income                          | <b>20.3</b>                        | 19.3   | <b>66.5</b>                       | 60.6    |
| Net realized capital gains                     | <b>10.2</b>                        | 2.8    | <b>25.8</b>                       | 6.3     |

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|  |                  |       |                   |       |
|--|------------------|-------|-------------------|-------|
| <i>Total investment operations segment</i>                                 | <b>30.5</b>      | 22.1  | <b>92.3</b>       | 66.9  |
| All other  | <b>0.3</b>       | (0.1) | <b>(0.3)</b>      | (0.1) |
| <i>Total segment loss before tax expense (benefit)</i>                     | <b>(50.7)</b>    | (2.6) | <b>(178.0)</b>    | (8.1) |
| Reconciling items:   |                  |       |                   |       |
| GAAP expense adjustments   | <b>0.5</b>       | 4.8   | <b>10.9</b>       | 5.7   |
| Interest expense on corporate debt   | <b>(1.9)</b>     | (1.7) | <b>(5.4)</b>      | (5.3) |
| Corporate expenses   | <b>0.1</b>       | (0.7) | <b>(1.7)</b>      | (1.9) |
| <i>Total reconciling items</i>   | <b>(1.3)</b>     | 2.4   | <b>3.8</b>        | (1.5) |
| <i>Total consolidated loss before federal income tax expense (benefit)</i> | <b>\$ (52.0)</b> | (0.2) | <b>\$ (174.2)</b> | (9.6) |

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The following table sets forth revenues from external sources for reportable segments for the three and nine months ended September 30, 2011 and 2010:

| <i>(\$ millions)</i>                            | Three months ended<br>September 30 |       | Nine months ended<br>September 30 |       |
|---|------------------------------------|-------|-----------------------------------|-------|
|   | <b>2011</b>                        | 2010  | <b>2011</b>                       | 2010  |
| <b>Earned premiums:</b>                         |                                    |       |                                   |       |
| <b>Personal insurance:</b>                      |                                    |       |                                   |       |
| Personal auto                                   | <b>\$ 121.4</b>                    | 128.4 | <b>\$ 373.0</b>                   | 379.6 |
| Homeowners                                      | <b>68.3</b>                        | 65.1  | <b>204.7</b>                      | 190.6 |
| Other personal                                  | <b>8.8</b>                         | 8.2   | <b>26.3</b>                       | 24.5  |
| <i>Total personal insurance earned premiums</i> | <b>198.5</b>                       | 201.7 | <b>604.0</b>                      | 594.7 |
| <b>Business insurance:</b>                      |                                    |       |                                   |       |
| Commercial auto                                 | <b>23.5</b>                        | 24.5  | <b>70.4</b>                       | 74.3  |
| Commercial multi-peril                          | <b>26.0</b>                        | 24.0  | <b>76.8</b>                       | 70.9  |
| Fire & allied lines                             | <b>23.3</b>                        | 24.1  | <b>71.1</b>                       | 73.5  |
| Other & product liability                       | <b>16.2</b>                        | 16.9  | <b>49.1</b>                       | 52.1  |
| Other business                                  | <b>5.3</b>                         | 5.8   | <b>16.4</b>                       | 17.1  |
| <i>Total business insurance earned premiums</i> | <b>94.3</b>                        | 95.3  | <b>283.8</b>                      | 287.9 |
| Specialty insurance                             | <b>64.0</b>                        | 21.0  | <b>171.6</b>                      | 47.3  |
| <i>Total SAP earned premiums</i>                | <b>356.8</b>                       | 318.0 | <b>1,059.4</b>                    | 929.9 |
| GAAP premium adjustment                         |                                    | 0.3   |                                   |       |
| <i>Total GAAP earned premiums</i>               | <b>356.8</b>                       | 318.3 | <b>1,059.4</b>                    | 929.9 |
| <b>Investment operations:</b>                   |                                    |       |                                   |       |
| Net investment income                           | <b>20.3</b>                        | 19.3  | <b>66.5</b>                       | 60.6  |
| Net realized capital gains                      | <b>10.2</b>                        | 2.8   | <b>25.8</b>                       | 6.3   |
| <i>Total investment operations</i>              | <b>30.5</b>                        | 22.1  | <b>92.3</b>                       | 66.9  |
| <i>Total revenues from reportable segments</i>  | <b>\$ 387.3</b>                    | 340.4 | <b>\$ 1,151.7</b>                 | 996.8 |

Investable assets attributable to our investment operations segment totaled \$2,546.0 million at September 30, 2011 and \$2,395.4 million at December 31, 2010.



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**12. Contingencies and Litigation**

The following describes significant pending legal proceedings, other than ordinary routine litigation incidental to our business, to which State Auto Financial or any of its subsidiaries is a party or to which any of our property is subject:

In December 2010, a putative class action lawsuit (Kelly vs. State Automobile Mutual Insurance Company, et al.) was filed against State Auto Financial, State Auto P&C and State Auto Mutual in state court in Ohio. In this lawsuit, plaintiffs allege that the defendants have engaged, and continue to engage, in deceptive practices by failing to disclose to plaintiffs the availability, through one or more related companies, of insurance policies providing for identical coverage and service as those policies purchased by plaintiffs but at a lower premium amount. Plaintiffs are seeking class certification and compensatory and punitive damages to be determined by the court and restitution and/or disgorgement of profits derived from plaintiffs and the alleged class. The Company believes its practices with respect to pricing, quoting and selling its insurance policies are in compliance with all applicable laws, and deny any and all liability to plaintiffs or the alleged class, and intend to vigorously defend this lawsuit.

Based on the Company's current understanding and assessment of this case, it does not expect this matter to have a material adverse effect on its results of operations.

*Other* The Company is involved in a number of lawsuits, and may become involved in other potential litigation, arising in the ordinary course of its business. Generally, the Company's involvement in a lawsuit involves defending third-party claims brought against its insureds in its role as liability insurer or against the Company as a principal of surety bonds, as well as defending policy coverage claims brought against the Company or the Company's business practice. The Company considers all lawsuits relating to insurance claims 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 when it is probable that such a liability has been incurred and the amount can be reasonably estimated. Based on currently available information known to the Company, the Company believes that its reserves for litigation-related liabilities are reasonable. Given the inherent uncertainty surrounding the ultimate resolution of these legal proceedings, an adverse outcome could have a material impact to the Company's results of operations in a future period, though in the opinion of the Company's management, none would likely have a material adverse effect on its consolidated financial or cash flow position.

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

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**13. Subsequent Events**

On November 4, 2011, the Board of Directors of State Auto Financial approved proposed changes to the Pooling Arrangement to reduce the overall participation percentage of the STFC Pooled Companies from 80% to 65%. These proposed changes are to be effective December 31, 2011, and are subject to regulatory approval by various departments of insurance. If approved, in conjunction with these changes, the STFC Pooled Companies will transfer net assets (cash and/or investment securities) of approximately \$275.0 million to \$325.0 million to the Mutual Pooled Companies for the net liabilities transferred. The transfer on December 31, 2011, is not expected to have a material impact on stockholders' equity or book value per share.

On November 4, 2011, the Company amended its postretirement healthcare benefit plan to change eligibility requirements for participation of its employees and certain retirees in this plan. This change will allow the Company to better manage its overall costs while addressing volatility on its balance sheet. As of September 30, 2011, on a pro forma basis, the estimated pre-tax incremental effect of this change on the condensed consolidated balance sheet would have increased stockholders' equity by approximately \$100.0 million, which includes an estimated pre-tax curtailment gain of approximately \$80.0 million.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

The term "State Auto Financial" as used below refers only to State Auto Financial Corporation and the terms "our Company," "we," "us," and "our" used below refer to State Auto Financial Corporation and its consolidated subsidiaries. For a glossary of terms for State Auto Financial Corporation and its subsidiaries and affiliates and a glossary of selected terms including insurance terms, see the section entitled "Important Defined Terms Used in this Form 10-K" included in our Annual Report on Form 10-K for the year ended December 31, 2010 (the "2010 Form 10-K").

The discussion and analysis presented below relates to the material changes in financial condition and results of operations for our consolidated balance sheets as of September 30, 2011 and December 31, 2010, and for the consolidated statements of income for the three and nine months ended September 30, 2011 and 2010. This discussion and analysis should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the 2010 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 2010 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 2010 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.

Prior to January 1, 2011, we operated in three reportable segments—personal insurance, business insurance and investment operations. In 2010, management focused on assessing and positioning a realignment of our internal organization, including people, processes and compensation reward programs, to be more strategic in the personal, business and specialty insurance markets. Considering these internal changes and the 2011 pooling change (defined below), beginning with the first quarter 2011, our reportable insurance segments became personal insurance, business insurance and specialty insurance (collectively the "insurance segments"), along with investment operations, which aligned how these insurance segments report to our principal operating decision makers. See "Personal and Business Insurance" and "Specialty Insurance" in Item 1 of the 2010 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2011 is set forth in Note 11 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q. Prior period segment information has been restated to conform to current period presentation.

Insurance industry regulators require our insurance subsidiaries to report their financial condition and results of operations using SAP. We use SAP financial results, along with industry standard financial measures determined on a SAP basis and certain measures determined on a GAAP basis, to internally monitor the performance of our insurance segments and reward our employees. One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred acquisition costs, see "Critical Accounting Policies—Deferred Acquisition Costs" section included in Item 7 of our 2010 Form 10-K.

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



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**POOLING ARRANGEMENT**

The STFC Pooled Companies and the Mutual Pooled Companies participate in a quota share reinsurance pooling arrangement referred to as the Pooling Arrangement. Under the Pooling Arrangement, State Auto Mutual assumes premiums, losses and expenses from each of the remaining Pooled Companies and in turn cedes to each of the Pooled Companies a specified portion of premiums, losses and expenses based on each of the Pooled Companies' respective pooling percentages. State Auto Mutual then retains the balance of the pooled business. The participation percentage for the STFC Pooled Companies has been at 80% since 2001.

On November 4, 2011, the Board of Directors of State Auto Financial approved a proposed amendment to the Pooling Arrangement to reduce the overall participation percentage of the STFC Pooled Companies from 80% to 65%. This proposed amendment is to be effective December 31, 2011, and is subject to regulatory approval by various departments of insurance. See also the Liquidity and Capital Resources Capital Position section in this Item for additional information on the proposed changes to the Pooling Arrangement.

As of January 1, 2010, the Pooling Arrangement was amended (the 2010 pooling changes) to add SA National with a participation percentage of 0.0% and to include voluntary assumed reinsurance from third parties unaffiliated with the Pooled Companies that was assumed on or after January 1, 2009. In conjunction with the 2010 pooling changes, the STFC Pooled Companies received \$3.7 million in cash from the Mutual Pooled Companies, for net insurance assets transferred on January 1, 2010.

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

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

State Auto Financial sold its nonstandard automobile insurance subsidiary, SA National, to a third party on December 31, 2010. Concurrently with this sale, SA National's participation in the Pooling Arrangement was terminated, and we entered into a loss portfolio transfer and a 100% quota share reinsurance agreements on December 31, 2010 to assume liability for the pre- and post-closing book of business of SA National, including providing policy and claims service to SA National policyholders, until policies are renewed with the third party purchaser on such purchaser's systems during a transition period of up to six months following effective date of sale. The transition was completed as of June 30, 2011; however, we still continue to service the remaining policies that were written by us through June 30, 2011. This business assumed by us is subject to the Pooling Arrangement.



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

|   | January 1, 2010<br>December 31, 2010 | January 1, 2011<br>September 30, 2011 |
|---|--------------------------------------|---------------------------------------|
| <b>STFC Pooled Companies:</b>                   |                                      |                                       |
| State Auto P&C                                  | 59.0%                                | 59.0%                                 |
| Milbank   | 17.0                                 | 17.0                                  |
| Farmers   | 3.0                                  | 3.0                                   |
| SA Ohio   | 1.0                                  | 1.0                                   |
| SA National                                     | 0.0                                  | N/A                                   |
| <i>Total STFC Pooled Companies</i>              | 80.0                                 | 80.0                                  |
| <b>State Auto Mutual Pooled Companies:</b>      |                                      |                                       |
| State Auto Mutual                               | 19.0                                 | 19.0                                  |
| SA Wisconsin                                    | 0.0                                  | 0.0                                   |
| SA Florida                                      | 0.0                                  | 0.0                                   |
| Meridian Security                               | 0.0                                  | 0.0                                   |
| Meridian Citizens Mutual                        | 0.5                                  | 0.5                                   |
| Beacon National                                 | 0.0                                  | 0.0                                   |
| Patrons Mutual                                  | 0.4                                  | 0.4                                   |
| Litchfield                                      | 0.1                                  | 0.1                                   |
| RIC   | N/A                                  | 0.0                                   |
| Plaza   | N/A                                  | 0.0                                   |
| American Compensation                           | N/A                                  | 0.0                                   |
| Bloomington Compensation                        | N/A                                  | 0.0                                   |
| <i>Total State Auto Mutual Pooled Companies</i> | 20.0                                 | 20.0                                  |

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**RESULTS OF OPERATIONS**

During the three and nine months ended September 30, 2011, we recognized a net loss of \$58.7 million and \$247.4 million, respectively, compared to net income of \$0.2 million and net loss of \$13.1 million for the same respective 2010 periods. For the three and nine months ended September 30, 2011, our net losses include a non-cash charge of \$28.9 million and \$143.8 million related to a valuation allowance against our net deferred tax asset.

During the three and nine months ended September 30, 2011, we recognized pretax losses of \$52.0 million and \$174.2 million, respectively, compared to pretax losses of \$0.2 million and \$9.6 million for the same respective 2010 periods.

The year to date 2011 results of our personal and business insurance segments have been significantly and negatively impacted by weather-related catastrophe losses, primarily arising from a hurricane, tornadoes, and wind and hail storms, which have impacted 32 of our operating states, including Hurricane Irene in late August and devastating tornadoes in Tuscaloosa, Alabama on April 27 and in Joplin, Missouri on May 22. Our third quarter 2011 results included a \$25.5 million increase in the estimate of prior quarter catastrophe losses.



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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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**Insurance Segments**

We market a broad line of property and casualty insurance products in all 50 states and the District of Columbia exclusively through independent insurance agencies and wholesale brokers. In our personal insurance segment we primarily provide personal auto and homeowners to the personal insurance market. In our business insurance segment we primarily provide commercial auto, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. In our specialty insurance segment we provide commercial coverages, including workers' compensation coverage for both legacy State Auto Group and RTW, Inc. insurance subsidiaries, which require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources.

The following tables set forth a summary of our SAP underwriting loss and SAP combined ratio for each of our insurance segments for the three and nine months ended September 30, 2011 and 2010:

(\$ millions)

|  | Three months ended<br>September 30, 2011 |       |          |       |           |       |        |       |
|--|--|-------|----------|-------|-----------|-------|--------|-------|
|  | Personal                                 | Ratio | Business | Ratio | Specialty | Ratio | Total  | Ratio |
| Written premiums                             | \$ 208.9                                 |       | 92.1     |       | 74.1      |       | 375.1  |       |
| Earned premiums                              | 198.5                                    |       | 94.3     |       | 64.0      |       | 356.8  |       |
| Losses and loss expenses                     | 177.8                                    | 89.5  | 84.5     | 89.6  | 52.2      | 81.7  | 314.5  | 88.1  |
| Underwriting expenses                        | 54.4                                     | 26.1  | 40.5     | 43.9  | 28.9      | 39.0  | 123.8  | 33.0  |
| SAP underwriting loss and SAP combined ratio | \$ (33.7)                                | 115.6 | (30.7)   | 133.5 | (17.1)    | 120.7 | (81.5) | 121.1 |

(\$ millions)

|  | Three months ended<br>September 30, 2010 |       |          |       |           |       |        |       |
|--|--|-------|----------|-------|-----------|-------|--------|-------|
|  | Personal                                 | Ratio | Business | Ratio | Specialty | Ratio | Total  | Ratio |
| Written premiums                             | \$ 217.1                                 |       | 92.8     |       | 41.4      |       | 351.3  |       |
| Earned premiums                              | 201.7                                    |       | 95.3     |       | 21.0      |       | 318.0  |       |
| Losses and loss expenses                     | 142.0                                    | 70.4  | 76.1     | 79.9  | 12.7      | 60.3  | 230.8  | 72.6  |
| Underwriting expenses                        | 60.2                                     | 27.7  | 35.3     | 38.1  | 16.3      | 39.2  | 111.8  | 31.8  |
| SAP underwriting loss and SAP combined ratio | \$ (0.5)                                 | 98.1  | (16.1)   | 118.0 | (8.0)     | 99.5  | (24.6) | 104.4 |

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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(\$ millions)

|  |            |       | Nine months ended<br>September 30, 2011 |       |           |       |         |       |  |
|--|------------|-------|---|-------|-----------|-------|---------|-------|--|
|  | Personal   | Ratio | Business                                | Ratio | Specialty | Ratio | Total   | Ratio |  |
| Written premiums <sup>(1)</sup>              | \$ 610.1   |       | 289.3                                   |       | 239.9     |       | 1,139.3 |       |  |
| Earned premiums                              | 604.0      |       | 283.8                                   |       | 171.6     |       | 1,059.4 |       |  |
| Losses and loss expenses                     | 579.4      | 95.9  | 249.6                                   | 88.0  | 128.8     | 75.1  | 957.8   | 90.4  |  |
| Underwriting expenses                        | 157.6      | 25.8  | 121.9                                   | 42.1  | 92.1      | 38.4  | 371.6   | 32.6  |  |
| SAP underwriting loss and SAP combined ratio | \$ (133.0) | 121.7 | (87.7)                                  | 130.1 | (49.3)    | 113.5 | (270.0) | 123.0 |  |

(\$ millions)

|  |           |       | Nine months ended<br>September 30, 2010 |       |           |       |         |       |  |
|--|-----------|-------|---|-------|-----------|-------|---------|-------|--|
|  | Personal  | Ratio | Business                                | Ratio | Specialty | Ratio | Total   | Ratio |  |
| Written premiums <sup>(2)</sup>              | \$ 625.3  |       | 291.3                                   |       | 89.3      |       | 1,005.9 |       |  |
| Earned premiums                              | 594.7     |       | 287.9                                   |       | 47.3      |       | 929.9   |       |  |
| Losses and loss expenses                     | 439.7     | 73.9  | 208.3                                   | 72.4  | 31.8      | 67.0  | 679.8   | 73.1  |  |
| Underwriting expenses                        | 178.2     | 28.5  | 111.7                                   | 38.4  | 35.1      | 39.2  | 325.0   | 32.3  |  |
| SAP underwriting loss and SAP combined ratio | \$ (23.2) | 102.4 | (32.1)                                  | 110.8 | (19.6)    | 106.2 | (74.9)  | 105.4 |  |

<sup>(1)</sup> Includes a one-time transfer of \$34.1 million of unearned premiums by the Rockhill Insurers to our specialty insurance segment on January 1, 2011, in conjunction with the 2011 pooling change. In connection with this unearned premium transfer, we paid a one-time ceding commission of \$8.3 million to the Rockhill Insurers. Combined, these one-time transactions benefitted our specialty insurance segment's statutory expense ratio by 2.3 points and total expense ratio by 0.3 points.

<sup>(2)</sup> Includes a one-time transfer of \$1.4 million of unearned premiums to the Mutual Pooled Companies on January 1, 2010, in conjunction with the 2010 pooling changes (transfer of \$2.1 million of our personal insurance segment and receipt of \$0.7 million of the Mutual Pooled Companies' specialty insurance segment).

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*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 term of the policies.

The following table sets forth the reconciliation of the one-time impact on net written premiums for the nine months ended September 30, 2011, of the unearned premiums transferred by the Rockhill Insurers on January 1, 2011, in conjunction with the 2011 pooling change:

| <i>(\$ millions)</i>                | Net Written Premiums Reconciliation Table |                             |                                |
|-------------------------------------|---|-----------------------------|--------------------------------|
|                                     | Including<br>pooling<br>change            | Pooling<br>change<br>impact | Excluding<br>pooling<br>change |
| <u>Personal insurance segment:</u>  |   |                             |                                |
| Personal auto                       | \$ 370.3                                  |                             | 370.3                          |
| Homeowners                          | 212.2                                     |                             | 212.2                          |
| Other personal                      | 27.6                                      |                             | 27.6                           |
| <i>Total personal</i>               | 610.1                                     |                             | 610.1                          |
| <u>Business insurance segment:</u>  |   |                             |                                |
| Commercial auto                     | 71.7                                      |                             | 71.7                           |
| Commercial multi-peril              | 82.2                                      |                             | 82.2                           |
| Fire & allied lines                 | 70.3                                      |                             | 70.3                           |
| Other & product liability           | 48.6                                      |                             | 48.6                           |
| Other commercial                    | 16.5                                      |                             | 16.5                           |
| <i>Total business</i>               | 289.3                                     |                             | 289.3                          |
| <u>Specialty insurance segment:</u> |   |                             |                                |
| RED                                 | 97.3                                      |                             | 97.3                           |
| Rockhill                            | 77.3                                      | 24.3                        | 53.0                           |
| Workers compensation                | 65.3                                      | 9.8                         | 55.5                           |
| <i>Total specialty</i>              | 239.9                                     | 34.1                        | 205.8                          |
| <i>Total net written premiums</i>   | \$ 1,139.3                                | 34.1                        | 1,105.2                        |



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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth the reconciliation of the one-time impact on net written premiums for the nine months ended September 30, 2010, of the unearned premiums transferred to the Mutual Pooled Companies on January 1, 2010, in conjunction with the 2010 pooling changes:

| <i>(\$ millions)</i>                       | Net Written Premiums Reconciliation Table |                             |                                |
|--|---|-----------------------------|--------------------------------|
|  | Including<br>pooling<br>change            | Pooling<br>change<br>impact | Excluding<br>pooling<br>change |
| <b><u>Personal insurance segment:</u></b>  |   |                             |                                |
| Personal auto                              | \$ 394.2                                  | (2.1)                       | 396.3                          |
| Homeowners                                 | 205.7                                     |                             | 205.7                          |
| Other personal                             | 25.4                                      |                             | 25.4                           |
| <i>Total personal</i>                      | 625.3                                     | (2.1)                       | 627.4                          |
| <b><u>Business insurance segment:</u></b>  |   |                             |                                |
| Commercial auto                            | 74.1                                      |                             | 74.1                           |
| Commercial multi-peril                     | 75.2                                      |                             | 75.2                           |
| Fire & allied lines                        | 72.5                                      |                             | 72.5                           |
| Other & product liability                  | 52.2                                      |                             | 52.2                           |
| Other commercial                           | 17.3                                      |                             | 17.3                           |
| <i>Total business</i>                      | 291.3                                     |                             | 291.3                          |
| <b><u>Specialty insurance segment:</u></b> |   |                             |                                |
| RED  | 56.1                                      | 0.7                         | 55.4                           |
| Rockhill                                   | 2.5                                       |                             | 2.5                            |
| Workers compensation                       | 30.7                                      |                             | 30.7                           |
| <i>Total specialty</i>                     | 89.3                                      | 0.7                         | 88.6                           |
| <i>Total net written premiums</i>          | \$ 1,005.9                                | (1.4)                       | 1,007.3                        |

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*Personal Insurance Segment Revenue*

Net written premiums for our personal insurance segment represented 55.7%, and 61.8% of our total consolidated net written premiums for the three months ended September 30, 2011 and 2010, respectively, and 55.2% and 62.3% of our total consolidated net written premiums for the nine months ended September 30, 2011 and 2010, respectively. The percentage decrease in this segment's share of our total consolidated net written premiums was primarily due to a decrease in net written premiums generated from this segment and an increase in the net written premiums generated from our specialty insurance segment, discussed below. This change is consistent with our long term plan for product diversification.

The following table sets forth a summary of written premium, net of reinsurance, by major product line of business for our personal insurance segment for the three and nine months ended September 30, 2011 and 2010. The one-time impacts of the 2011 and 2010 pooling changes have been excluded from 2011 and 2010 to present net written premiums on a comparative basis (see Net Written Premium Reconciliation Tables above).

| (\$ millions)                      | Three months ended<br>September 30 |       |             | Nine months ended<br>September 30 |       |             |
|------------------------------------|------------------------------------|-------|-------------|-----------------------------------|-------|-------------|
|                                    | Net Written Premiums               |       |             | Net Written Premiums              |       |             |
|                                    | 2011                               | 2010  | %<br>Change | 2011                              | 2010  | %<br>Change |
| <b>Personal insurance segment:</b> |                                    |       |             |                                   |       |             |
| Personal auto                      | \$ 123.5                           | 134.1 | (7.9)       | \$ 370.3                          | 396.3 | (6.6)       |
| Homeowners                         | 76.3                               | 74.8  | 2.0         | 212.2                             | 205.7 | 3.2         |
| Other personal                     | 9.1                                | 8.2   | 11.0        | 27.6                              | 25.4  | 8.7         |
| <b>Total personal</b>              | <b>\$ 208.9</b>                    | 217.1 | (3.8)       | <b>\$ 610.1</b>                   | 627.4 | (2.8)       |

Personal auto net written premiums for the three and nine months ended September 30, 2011 decreased 7.9% and 6.6%, respectively, compared to the same 2010 periods. The loss of premiums caused by the sale of our nonstandard automobile insurance subsidiary, SA National, in 2010 accounted for a significant portion of this decrease. While we are experiencing a decline in premiums in our personal auto business, we continue to grow premiums in several states consistent with our strategy to expand our geographic footprint outside the Midwest. Much of this premium growth is from our expansion states of Texas, Colorado, Connecticut and Georgia. While the personal auto quote activity continues to be strong, we are experiencing a slowdown in new business and a lower issue-to-quote ratio which we believe is attributable to the impact of our rate increases. We also have a high percentage of auto policies for which we write the companion home policy. Consequently, we believe the aggressive actions we have been implementing to address profit levels in homeowners is impacting the entire account and causing the loss of some auto policies, which is also contributing to the slowdown of new business.

Homeowners net written premiums for the three and nine months ended September 30, 2011 increased 2.0% and 3.2%, respectively, compared to the same 2010 periods. The primary driver contributing to this premium growth was rate increases. While we have seen declines in our policy counts from our core states of Ohio, Kentucky, and Indiana, we have seen policy count growth in states that we have either expanded into or identified as profitable growth opportunities. We continue to aggressively address our rate needs.



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*Business Insurance Segment Revenue*

In our business insurance segment, our accounts are primarily small-to-medium sized exposures where we offer a broad range of both property and liability coverage. Net written premiums for our business insurance segment represented 24.6% and 26.4% of our total consolidated net written premiums for the three months ended September 30, 2011 and 2010, respectively, and 26.2% and 28.9% of our total consolidated net written premiums for the nine months ended September 30, 2011 and 2010, respectively.

The following table sets forth a summary of written premiums, net of reinsurance, by major product line of business for our business insurance segment for the three and nine months ended September 30, 2011 and 2010. The one-time impacts of the 2011 and 2010 pooling changes have been excluded from 2011 and 2010 to present net written premiums on a comparative basis (see Net Written Premiums Reconciliation Tables above).

| (\$ millions)                      | Three months ended<br>September 30 |             |              | Nine months ended<br>September 30 |              |              |
|------------------------------------|------------------------------------|-------------|--------------|-----------------------------------|--------------|--------------|
|                                    | 2011                               | 2010        | %<br>Change  | 2011                              | 2010         | %<br>Change  |
| <b>Business insurance segment:</b> |                                    |             |              |                                   |              |              |
| Commercial auto                    | \$ 21.6                            | 22.3        | (3.1)        | \$ 71.7                           | 74.1         | (3.2)        |
| Commercial multi-peril             | 27.5                               | 25.4        | 8.3          | 82.2                              | 75.2         | 9.3          |
| Fire & allied lines                | 22.9                               | 23.5        | (2.6)        | 70.3                              | 72.5         | (3.0)        |
| Other & product liability          | 14.8                               | 16.0        | (7.5)        | 48.6                              | 52.2         | (6.9)        |
| Other commercial                   | 5.3                                | 5.6         | (5.4)        | 16.5                              | 17.3         | (4.6)        |
| <b>Total business</b>              | <b>\$ 92.1</b>                     | <b>92.8</b> | <b>(0.8)</b> | <b>\$ 289.3</b>                   | <b>291.3</b> | <b>(0.7)</b> |

Net written premiums for the business insurance segment for the three and nine months ended September 30, 2011 decreased 0.8% and 0.7%, respectively, compared to the same 2010 periods. Business insurance continues to be impacted by rate competition, general economic conditions, and depressed premium bases, such as payrolls, sales and number of vehicles, as well as ease of doing business issues. After strengthening our premium per exposure on our renewal policies in the second half of 2009, our premium per exposure decreased slightly in 2010, and this trend has continued through the first nine months of 2011. We experienced a single digit increase in premiums related to new business, in the third quarter 2011. Despite new business growth, we believe it will be difficult to generate measurable premium growth in our current book of business given the continued impact of the economy on premium bases. However, we are seeking to balance our traditional underwriting discipline with new products and pricing tools that support the production of profitable new business.

In 2011, we began introducing policy download capabilities for most business insurance lines, which allows agents to import policy information directly into their agency management systems to better serve their clients. Commercial auto is currently available for our agents to download, and we expect to have download capabilities available for our businessowners and workers compensation lines by the end of 2011.

We have also expanded the eligibility of our businessowners products to facilitate businesses with greater liability exposures, such as artisan contractors, auto service garages, manufacturers and restaurants. While we regularly insure these types of businesses through other insurance products, offering these products in our businessowners program leverages our bizXpress<sup>SM</sup> technology, simplifies agents rating and submission processes, and offers broader base coverages for these types of risks. In 2010, we completed the implementation of our enhanced

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businessowners product, BOP Choice, which has been introduced into 30 states. The majority of our new business premium has been generated from this new product, which is included in our commercial multi-peril line. Our

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product revisions have also produced a greater proportion of casualty business, which we believe is desirable given our Midwest property concentrations.

*Specialty Insurance Segment Revenue*

In our specialty insurance segment, we offer commercial coverages that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. Net written premiums for our specialty insurance segment represented 19.8% and 11.8% of our total consolidated net written premiums for the three months ended September 30, 2011 and 2010, respectively, and 18.6% and 8.8% of our total consolidated net written premiums for the nine months ended September 30, 2011 and 2010, respectively. In addition to an overall increase in the net written premiums generated by this segment, the percentage increase in this segment's share of our total consolidated net written premiums was impacted by the decrease in net written premiums in our personal insurance segment, discussed above. This change is consistent with our long term plan for product diversification.

The following table sets forth a summary of written premiums, net of reinsurance, by unit for our specialty insurance segment for the three and nine months ended September 30, 2011 and 2010. The one-time impacts of the 2011 and 2010 pooling changes have been excluded from 2011 and 2010 to present net written premiums on a comparative basis (see Net Written Premiums Reconciliation Tables above).

| (\$ millions)                       | Three months ended<br>September 30 |      |             | Nine months ended<br>September 30 |      |             |
|-------------------------------------|------------------------------------|------|-------------|-----------------------------------|------|-------------|
|                                     | 2011                               | 2010 | %<br>Change | 2011                              | 2010 | %<br>Change |
| <b>Specialty insurance segment:</b> |                                    |      |             |                                   |      |             |
| RED                                 | \$ 38.0                            | 31.0 | 22.6        | \$ 97.3                           | 55.4 | 75.6        |
| Rockhill                            | 17.2                               | 0.9  | 1,811.1     | 53.0                              | 2.5  | 2,020.0     |
| Workers compensation                | 18.9                               | 9.5  | 98.9        | 55.5                              | 30.7 | 80.8        |
| <b>Total specialty</b>              | <b>\$ 74.1</b>                     | 41.4 | 79.0        | <b>\$ 205.8</b>                   | 88.6 | 132.3       |

Net written premiums for the specialty insurance segment for the three and nine months ended September 30, 2011 increased \$32.7 million and \$117.2 million, respectively, compared to the same 2010 periods. The increase in net written premiums for the specialty insurance segment was principally driven by the addition of the Rockhill Insurers' business to the Pooling Arrangement and increased business written through our RED unit.

Net written premiums for our RED unit for the three and nine months ended September 30, 2011 increased \$7.0 million and \$41.9 million compared to the same 2010 periods. This business was new to us in 2010, as the underwriting management agreement with RED went into effect during the fourth quarter 2009. Commercial auto coverage contributed to this growth for the three and nine month periods.

The premium growth in the Rockhill and workers compensation units was primarily due to the addition of the Rockhill Insurers' business into the Pooling Arrangement in 2011.



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

The following table sets forth, on a pro forma basis, specialty insurance segment net written premiums for the three and nine months ended September 30, 2011 and 2010, as if the Rockhill Insurers' business had been included in our net written premium results for the three and nine months ended September 30, 2010.

| (\$ millions)                       | Three months ended<br>September 30 |                      |             | Nine months ended<br>September 30 |                      |             |
|-------------------------------------|------------------------------------|----------------------|-------------|-----------------------------------|----------------------|-------------|
|                                     | Net Written Premiums               |                      |             |                                   |                      |             |
|                                     | 2011                               | Pro<br>Forma<br>2010 | %<br>Change | 2011                              | Pro<br>Forma<br>2010 | %<br>Change |
| <b>Specialty insurance segment:</b> |                                    |                      |             |                                   |                      |             |
| RED                                 | \$ 38.0                            | 31.0                 | 22.6        | \$ 97.3                           | 55.4                 | 75.6        |
| Rockhill                            | 17.2                               | 10.7                 | 60.7        | 53.0                              | 41.6                 | 27.4        |
| Workers' compensation               | 18.9                               | 15.6                 | 21.2        | 55.5                              | 48.4                 | 14.7        |
| <b>Total specialty</b>              | <b>\$ 74.1</b>                     | <b>57.3</b>          | <b>29.3</b> | <b>\$ 205.8</b>                   | <b>145.4</b>         | <b>41.5</b> |

On a pro forma basis, net written premiums for our Rockhill unit for the three and nine months ended September 30, 2011 increased \$6.5 million and \$11.4 million, respectively, compared to the same 2010 periods. The three and nine month increases were impacted by the following.

Increased business opportunities resulting from the Rockhill Insurers' A.M. Best ratings upgrade from A- to A in 2011.

Increased property business opportunities through our excess and surplus channel for catastrophe exposed businesses due to recent global catastrophe events and recent industry catastrophe model changes. This business is written on a nonadmitted basis, which allows us to underwrite unique insurance requirements using customized rates and forms. This business is subject to an individual catastrophe treaty with a net retention of \$7.5 million for each occurrence. See Liquidity and Capital Resources Reinsurance Arrangements in this Item for recent changes to this unit's property catastrophe reinsurance program including the purchase of additional catastrophe reinsurance limits.

Recent rate and volume growth in our excess and surplus liability casualty lines, which we believe is attributable to early signs of stabilization in pricing in the commercial lines market.

Recent changes in the structure of two liability lines reinsurance programs, which resulted in our retaining additional written premium of \$5.8 million and \$9.4 million for the three and nine months ended September 30, 2011, respectively. See Liquidity and Capital Resources Reinsurance Arrangements section in this Item for recent changes to these programs.

On a pro forma basis, net written premiums for our workers' compensation unit for the three and nine months ended September 30, 2011 increased by \$3.3 million and \$7.1 million, respectively, when compared to the same 2010 periods. The premium growth in our workers' compensation unit was driven by increased renewal retention and rate increases in our larger accounts, which we believe is an indication that pricing levels within this line of business are improving.

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*Loss and LAE*

The following tables set forth our insurance segments' SAP loss and LAE ratios by major lines of business with the catastrophe and non-catastrophe impact shown separately for the three and nine months ended September 30, 2011 and 2010:

(\$ millions)

| Three months ended September 30, 2011 | Earned<br>Premium | Cat Loss<br>&<br>LAE | Non-Cat<br>Loss &<br>LAE | Statutory<br>Loss &<br>LAE | Cat<br>Ratio | Non-Cat<br>Ratio | Total Loss<br>and<br>LAE |
|---------------------------------------|-------------------|----------------------|--------------------------|----------------------------|--------------|------------------|--------------------------|
|                                       |                   |                      |                          |                            |              |                  | Ratio                    |
| <b>Statutory Loss and LAE Ratios</b>  |                   |                      |                          |                            |              |                  |                          |
| <u>Personal insurance segment:</u>    |                   |                      |                          |                            |              |                  |                          |
| Personal auto                         | \$ 121.4          | \$ 3.8               | \$ 87.4                  | \$ 91.2                    | 3.1          | 72.0             | 75.1                     |
| Homeowners                            | 68.3              | 39.4                 | 40.0                     | 79.4                       | 57.9         | 58.4             | 116.3                    |
| Other personal                        | 8.8               | 2.3                  | 4.9                      | 7.2                        | 25.6         | 55.6             | 81.2                     |
| <i>Total personal</i>                 | 198.5             | 45.5                 | 132.3                    | 177.8                      | 22.9         | 66.6             | 89.5                     |
| <u>Business insurance segment:</u>    |                   |                      |                          |                            |              |                  |                          |
| Commercial auto                       | 23.5              | 0.7                  | 16.4                     | 17.1                       | 2.8          | 70.0             | 72.8                     |
| Commercial multi-peril                | 26.0              | 5.7                  | 17.0                     | 22.7                       | 21.8         | 65.7             | 87.5                     |
| Fire & allied lines                   | 23.3              | 8.0                  | 15.8                     | 23.8                       | 34.3         | 68.0             | 102.3                    |
| Other & product liability             | 16.2              |                      | 19.3                     | 19.3                       |              | 119.1            | 119.1                    |
| Other commercial                      | 5.3               |                      | 1.6                      | 1.6                        | (0.6)        | 30.0             | 29.4                     |
| <i>Total business</i>                 | 94.3              | 14.4                 | 70.1                     | 84.5                       | 15.1         | 74.5             | 89.6                     |
| Specialty insurance segment           | 64.0              | 0.9                  | 51.3                     | 52.2                       | 1.5          | 80.2             | 81.7                     |
| <i>Total SAP</i>                      | \$ 356.8          | \$ 60.8              | \$ 253.7                 | \$ 314.5                   | 17.0         | 71.1             | 88.1                     |

(\$ millions)

| Three months ended September 30, 2010 | Earned<br>Premium | Cat Loss<br>&<br>LAE | Non-Cat<br>Loss &<br>LAE | Statutory<br>Loss &<br>LAE | Cat<br>Ratio | Non-Cat<br>Ratio | Total Loss<br>and<br>LAE |
|---------------------------------------|-------------------|----------------------|--------------------------|----------------------------|--------------|------------------|--------------------------|
|                                       |                   |                      |                          |                            |              |                  | Ratio                    |
| <b>Statutory Loss and LAE Ratios</b>  |                   |                      |                          |                            |              |                  |                          |
| <u>Personal insurance segment:</u>    |                   |                      |                          |                            |              |                  |                          |
| Personal auto                         | \$ 128.4          | \$ 0.6               | \$ 84.0                  | \$ 84.6                    | 0.4          | 65.5             | 65.9                     |
| Homeowners                            | 65.1              | 15.6                 | 35.3                     | 50.9                       | 23.9         | 54.3             | 78.2                     |
| Other personal                        | 8.2               | 1.3                  | 5.2                      | 6.5                        | 16.6         | 61.6             | 78.2                     |
| <i>Total personal</i>                 | 201.7             | 17.5                 | 124.5                    | 142.0                      | 8.7          | 61.7             | 70.4                     |
| <u>Business insurance segment:</u>    |                   |                      |                          |                            |              |                  |                          |
| Commercial auto                       | 24.5              |                      | 20.3                     | 20.3                       | 0.1          | 83.2             | 83.3                     |
| Commercial multi-peril                | 24.0              | 1.4                  | 15.0                     | 16.4                       | 5.6          | 62.4             | 68.0                     |

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|                             |          |         |          |          |      |      |      |
|-----------------------------|----------|---------|----------|----------|------|------|------|
| Fire & allied lines         | 24.1     | 4.8     | 14.7     | 19.5     | 19.9 | 60.8 | 80.7 |
| Other & product liability   | 16.9     |         | 16.2     | 16.2     |      | 95.8 | 95.8 |
| Other commercial            | 5.8      |         | 3.7      | 3.7      | 1.1  | 63.9 | 65.0 |
| <i>Total business</i>       | 95.3     | 6.2     | 69.9     | 76.1     | 6.6  | 73.3 | 79.9 |
| Specialty insurance segment | 21.0     |         | 12.7     | 12.7     |      | 60.3 | 60.3 |
| <i>Total SAP</i>            | \$ 318.0 | \$ 23.7 | \$ 207.1 | \$ 230.8 | 7.5  | 65.1 | 72.6 |

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

(\$ millions)

| Nine months ended September 30, 2011 | Earned<br>Premium | Cat Loss<br>& LAE | Non-Cat<br>Loss &<br>LAE | Statutory<br>Loss &<br>LAE | Cat<br>Ratio | Non-Cat<br>Ratio | Total Loss<br>and<br>LAE |
|--------------------------------------|-------------------|-------------------|--------------------------|----------------------------|--------------|------------------|--------------------------|
|                                      |                   |                   |                          |                            |              |                  | Ratio                    |
| <b>Statutory Loss and LAE Ratios</b> |                   |                   |                          |                            |              |                  |                          |
| <u>Personal insurance segment:</u>   |                   |                   |                          |                            |              |                  |                          |
| Personal auto                        | \$ 373.0          | \$ 16.7           | \$ 259.0                 | \$ 275.7                   | 4.5          | 69.4             | 73.9                     |
| Homeowners                           | 204.7             | 153.0             | 127.8                    | 280.8                      | 74.8         | 62.4             | 137.2                    |
| Other personal                       | 26.3              | 8.1               | 14.8                     | 22.9                       | 30.7         | 56.6             | 87.3                     |
| <i>Total personal</i>                | <b>604.0</b>      | <b>177.8</b>      | <b>401.6</b>             | <b>579.4</b>               | <b>29.4</b>  | <b>66.5</b>      | <b>95.9</b>              |
| <u>Business insurance segment:</u>   |                   |                   |                          |                            |              |                  |                          |
| Commercial auto                      | 70.4              | 3.1               | 46.1                     | 49.2                       | 4.4          | 65.6             | 70.0                     |
| Commercial multi-peril               | 76.8              | 22.8              | 46.1                     | 68.9                       | 29.7         | 60.0             | 89.7                     |
| Fire & allied lines                  | 71.1              | 27.4              | 47.1                     | 74.5                       | 38.6         | 66.2             | 104.8                    |
| Other & product liability            | 49.1              |                   | 50.6                     | 50.6                       |              | 103.1            | 103.1                    |
| Other commercial                     | 16.4              | 0.8               | 5.6                      | 6.4                        | 4.4          | 34.3             | 38.7                     |
| <i>Total business</i>                | <b>283.8</b>      | <b>54.1</b>       | <b>195.5</b>             | <b>249.6</b>               | <b>19.0</b>  | <b>69.0</b>      | <b>88.0</b>              |
| Specialty insurance segment          | 171.6             | 1.0               | 127.8                    | 128.8                      | 0.6          | 74.5             | 75.1                     |
| <i>Total SAP</i>                     | <b>\$ 1,059.4</b> | <b>\$ 232.9</b>   | <b>\$ 724.9</b>          | <b>957.8</b>               | <b>22.0</b>  | <b>68.4</b>      | <b>90.4</b>              |

(\$ millions)

| Nine months ended September 30, 2010 | Earned<br>Premium | Cat Loss<br>& LAE | Non-Cat<br>Loss &<br>LAE | Statutory<br>Loss &<br>LAE | Cat<br>Ratio | Non-Cat<br>Ratio | Total Loss<br>and<br>LAE |
|--------------------------------------|-------------------|-------------------|--------------------------|----------------------------|--------------|------------------|--------------------------|
|                                      |                   |                   |                          |                            |              |                  | Ratio                    |
| <b>Statutory Loss and LAE Ratios</b> |                   |                   |                          |                            |              |                  |                          |
| <u>Personal insurance segment:</u>   |                   |                   |                          |                            |              |                  |                          |
| Personal auto                        | \$ 379.6          | \$ 5.9            | \$ 240.7                 | \$ 246.6                   | 1.5          | 63.5             | 65.0                     |
| Homeowners                           | 190.6             | 57.3              | 118.9                    | 176.2                      | 30.0         | 62.4             | 92.4                     |
| Other personal                       | 24.5              | 4.4               | 12.5                     | 16.9                       | 18.3         | 50.2             | 68.5                     |
| <i>Total personal</i>                | <b>594.7</b>      | <b>67.6</b>       | <b>372.1</b>             | <b>439.7</b>               | <b>11.4</b>  | <b>62.5</b>      | <b>73.9</b>              |
| <u>Business insurance segment:</u>   |                   |                   |                          |                            |              |                  |                          |
| Commercial auto                      | 74.3              | 1.5               | 45.3                     | 46.8                       | 2.0          | 61.1             | 63.1                     |
| Commercial multi-peril               | 70.9              | 7.3               | 42.8                     | 50.1                       | 10.2         | 60.3             | 70.5                     |
| Fire & allied lines                  | 73.5              | 14.4              | 41.7                     | 56.1                       | 19.7         | 56.6             | 76.3                     |
| Other & product liability            | 52.1              |                   | 48.3                     | 48.3                       |              | 92.7             | 92.7                     |
| Other commercial                     | 17.1              | 0.5               | 6.5                      | 7.0                        | 3.1          | 38.5             | 41.6                     |
| <i>Total business</i>                | <b>287.9</b>      | <b>23.7</b>       | <b>184.6</b>             | <b>208.3</b>               | <b>8.2</b>   | <b>64.2</b>      | <b>72.4</b>              |
| Specialty insurance segment          | 47.3              |                   | 31.8                     | 31.8                       |              | 67.0             | 67.0                     |
| <i>Total SAP</i>                     | <b>\$ 929.9</b>   | <b>\$ 91.3</b>    | <b>\$ 588.5</b>          | <b>\$ 679.8</b>            | <b>9.8</b>   | <b>63.3</b>      | <b>73.1</b>              |



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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Our total SAP cat loss ratios for the three and nine months ended September 30, 2011 were 17.0 and 22.0, respectively, compared to 7.5 and 9.8 for the same 2010 periods. Included in our catastrophe losses for the third quarter was a \$25.5 million or 7.1 point increase in the estimate of prior quarter catastrophe losses, as well as losses from Hurricane Irene, both of which impacted homeowners. The increase in prior quarter catastrophe losses reflected increased estimates of claim severity as well as unexpected reporting patterns of losses in excess of \$50,000. Included in our catastrophe losses for the nine months ended September 30, 2011 were the Tuscaloosa, Alabama and Joplin, Missouri tornadoes. Approximately 60% of the losses generated from these catastrophes were concentrated in five states: Tennessee, Missouri, Ohio, Texas and Alabama. The frequency and severity of these storm losses were greater than what we have experienced in the past with higher levels of total losses affecting homes, businesses and cars.

In the personal insurance segment, the total SAP non-cat loss ratios for the three and nine months ended September 30, 2011 increased 4.9 points and 4.0 points, respectively, from the same 2010 periods. For the three and nine months ended September 30, 2011, our personal auto line of business was impacted by increases in liability claim frequency, including an increase in the number of large losses. For the three months ended September 30, 2011, our homeowners SAP non-cat loss ratio was negatively impacted by an increase in the number and severity of large non-weather related losses. For the nine months ended September 30, 2011 our homeowners SAP non-cat loss ratio was flat when compared to the same 2010 period. We continue to file rate increases in the high single to low double digit range in the homeowners line of business.

We continue to implement strategies to improve our homeowner results. As of third quarter 2011, our CustomFit<sup>SM</sup> homeowners product, which uses by-peril rating, had been deployed in 15 states, with plans of deployment in one additional state during 2011. We have placed a priority of introducing our CustomFit homeowners product in states which have historically experienced adverse catastrophe experience. States in which CustomFit homeowners is currently offered or will be offered in 2011 represent approximately 75% of our homeowners premium and account for 82% of our five year wind/hail losses.

In addition to rate increases and the continued deployment of our CustomFit homeowners product, we are aggressively evaluating and monitoring unprofitable agencies, which includes the review of an agency's existing policies, implementation of tighter new business and renewal guidelines for that agency, and/or the application of other loss mitigation tools for use by that agency, all with the purpose of improving operating results at the agency level. We are continuing with a proactive insurance to value program, which is designed to have our insureds maintain an amount of coverage sufficient to replace their home and contents in the case of a total loss consistent with our loss settlement practices. In addition, we have implemented mandatory wind and hail deductibles in 19 states.

In the business insurance segment, the total SAP non-cat loss ratios for the three and nine months ended September 30, 2011 increased 1.2 points and 4.8 points, respectively, from the same 2010 periods. The increase in this segment's total SAP non-cat loss ratio for the nine months ended September 30, 2011 from the same 2010 period was due primarily to an increase in weather related losses in the fire & allied lines and an increase in the number of large losses in the commercial auto and other & product liability lines. Intense competition in the business insurance segment continues to impact our ability to implement price increases. However, we continue to use modeled pricing in some lines of business to more accurately price individual accounts. In addition, new deductible guidelines have been introduced to require higher, wind only deductibles on risks that have multiple buildings at a single location susceptible to identified wind zones.

In the specialty insurance segment, the total SAP non-cat loss ratios for the three and nine months ended September 30, 2011 increased 19.9 points and 7.5 points, respectively, from the same 2010 periods. For the three and nine months ended September 30, 2011, the changes were primarily driven by an increase in reserves of \$5.4 million in certain life time disability claims in the workers' compensation line of business with approximately 60% of these losses occurring prior to 2006, as well as higher levels of large losses in the commercial auto line of business.

Over the past 18 months, we have implemented a number of changes to our liability claim handling process, which we believe have accelerated the reserving and resolution of outstanding liability claims. While we believe these actions will better control indemnity payouts and legal expenses in the long term, in the short term, we believe that such actions are increasing the number, but



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not the severity, of large casualty losses. We define a large loss as any claim, either newly or previously reported, which produces an incurred amount greater than \$100,000 in the period. We expect the impact of this more active claim file management to level out in the coming quarters.

The following table sets forth loss and loss expenses payable by major line of business at September 30, 2011 and December 31, 2010:

| <i>(\$ millions)</i>   | <b>September 30,<br/>2011</b> | December 31,<br>2010 | January 1,<br>2011 <sup>(1)</sup> | \$<br>Change <sup>(2)</sup> |
|--|-------------------------------|----------------------|-----------------------------------|-----------------------------|
| <b>Personal insurance segment:</b>   |                               |                      |                                   |                             |
| Personal auto  | \$ 242.8                      | 247.7                | 247.7                             | (4.9)                       |
| Homeowners   | 114.4                         | 80.7                 | 80.7                              | 33.7                        |
| Other personal   | 16.2                          | 12.8                 | 12.8                              | 3.4                         |
| <i>Total personal</i>  | <b>373.4</b>                  | 341.2                | 341.2                             | 32.2                        |
| <b>Business insurance segment:</b>   |                               |                      |                                   |                             |
| Commercial auto  | 95.8                          | 99.2                 | 99.2                              | (3.4)                       |
| Commercial multi-peril   | 97.8                          | 92.0                 | 92.0                              | 5.8                         |
| Fire & allied lines  | 38.7                          | 31.4                 | 31.4                              | 7.3                         |
| Other & product liability  | 195.9                         | 183.1                | 183.1                             | 12.8                        |
| Other business   | 4.9                           | 5.2                  | 5.2                               | (0.3)                       |
| <i>Total business</i>  | <b>433.1</b>                  | 410.9                | 410.9                             | 22.2                        |
| <b>Specialty insurance segment</b>   | <b>304.0</b>                  | 122.1                | 246.6                             | 57.4                        |
| <i>Total losses and loss expenses payable net of<br/>reinsurance recoverable on losses and loss expenses<br/>payable</i> | <b>\$ 1,110.5</b>             | 874.2                | 998.7                             | 111.8                       |

<sup>(1)</sup> The December 31, 2010 loss and loss expenses payable balance has been adjusted for comparative purposes to reflect the loss and loss expenses payable assumed from the Rockhill Insurers on January 1, 2011 due to the 2011 pooling change.

<sup>(2)</sup> Calculated based on September 30, 2011 change from January 1, 2011.

Loss and loss expenses payable increased \$111.8 million since January 1, 2011, due to catastrophe related losses in our homeowners, commercial multi-peril and fire & allied lines of business and growth in the specialty insurance segment. 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

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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

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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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 Critical Accounting Policies Loss and Loss Expenses Payable in Item 7 of the 2010 Form 10-K.

*Acquisition and Operating Expenses*

Our GAAP expense ratios were 34.0 and 32.8 for the three months ended September 30, 2011 and 2010, respectively, and 33.6 and 33.3 for the nine months ended September 30, 2011 and 2010, respectively.

Acquisition costs are typically deferred and amortized over the same period in which the related premiums are earned. On a quarterly basis, we review the loss ratio expectations used to determine our deferrable level of acquisition costs. Changes in these expectations will either increase or decrease the level of current period acquisition costs to be deferred when compared to prior periods and the rate of amortization of beginning period deferred costs over the remaining policy period. Changes to our loss ratio expectations, along with changes to our mix of business, may cause fluctuations in our expense ratio between quarterly periods. The difference between 2011 and 2010 quarterly expense ratio levels is primarily due to loss ratio expectations and mix of business between the two periods. On a 2011 year-to-date basis, the expense ratio was comparable to the same 2010 period.

**Investment Operations Segment**

For a more detailed discussion regarding the management of our investment portfolio, see Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Investment Operations Segment in Item 7 of the 2010 Form 10-K.

*Composition of Investment Portfolio*

The following table sets forth the composition of our investment portfolio at carrying value at September 30, 2011 and December 31, 2010:

| <i>(\$ millions)</i>                           | <b>September 30,<br/>2011</b> | <b>% of<br/>Total</b> | December 31,<br>2010 | % of<br>Total |
|--|-------------------------------|-----------------------|----------------------|---------------|
| Cash and cash equivalents                      | \$ 186.7                      | 7.3                   | \$ 88.3              | 3.7           |
| Fixed maturities, at fair value:               |                               |                       |                      |               |
| Fixed maturities                               | 1,781.4                       | 70.0                  | 1,705.2              | 71.2          |
| Treasury inflation-protected securities        | 259.7                         | 10.2                  | 195.5                | 8.2           |
| <i>Total fixed maturities</i>                  | <b>2,041.1</b>                | <b>80.2</b>           | 1,900.7              | 79.4          |
| Notes receivable from affiliate <sup>(1)</sup> | 70.0                          | 2.7                   | 70.0                 | 2.9           |
| Equity securities, at fair value:              |                               |                       |                      |               |
| Large-cap securities                           | 142.9                         | 5.6                   | 211.1                | 8.8           |
| Small-cap securities                           | 39.5                          | 1.6                   | 45.1                 | 1.9           |
| <i>Total equity securities</i>                 | <b>182.4</b>                  | <b>7.2</b>            | 256.2                | 10.7          |
| Other invested assets, at fair value:          |                               |                       |                      |               |
| International instruments                      | 60.9                          | 2.4                   | 75.3                 | 3.1           |

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|   |                   |              |            |       |
|---|-------------------|--------------|------------|-------|
| Other invested assets                             | <b>4.4</b>        | <b>0.2</b>   | 4.4        | 0.2   |
| <i>Total other invested assets, at fair value</i> | <b>65.3</b>       | <b>2.6</b>   | 79.7       | 3.3   |
| Other invested assets, at cost                    | <b>0.5</b>        | <b>0.0</b>   | 0.5        | 0.0   |
| <br>  |                   |              |            |       |
| <i>Total portfolio</i>                            | \$ <b>2,546.0</b> | <b>100.0</b> | \$ 2,395.4 | 100.0 |

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

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

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at September 30, 2011:

| <i>(\$ millions)</i>  | <b>Amortized<br/>cost</b> | <b>Fair<br/>value</b> |
|---|---------------------------|-----------------------|
| Due in 1 year or less   | \$ 49.0                   | 49.2                  |
| Due after 1 year through 5 years                                | 378.1                     | 393.1                 |
| Due after 5 years through 10 years                              | 542.8                     | 579.9                 |
| Due after 10 years  | 561.2                     | 595.1                 |
| U.S. government agencies residential mortgage-backed securities | 405.0                     | 423.8                 |
| <i>Total</i>  | <b>\$ 1,936.1</b>         | <b>2,041.1</b>        |

Expected maturities may differ from contractual maturities as the issuers may have the right to call or prepay the obligations with or without call or prepayment penalties. The duration of the fixed maturity portfolio was approximately 4.09 and 5.01 as of September 30, 2011 and December 31, 2010, respectively.

*Investment Operations Revenue*

The following table sets forth the components of net investment income for the three and nine months ended September 30, 2011 and 2010:

| <i>(\$ millions)</i>                   | Three months ended<br>September 30 |         | Nine months ended<br>September 30 |         |
|--|------------------------------------|---------|-----------------------------------|---------|
|  | <b>2011</b>                        | 2010    | <b>2011</b>                       | 2010    |
| <b><u>Gross investment income:</u></b> |                                    |         |                                   |         |
| Fixed maturities                       | \$ 18.4                            | 17.1    | \$ 60.2                           | 54.1    |
| Equity securities                      | 1.1                                | 1.4     | 3.8                               | 4.0     |
| Other                                  | 1.4                                | 1.4     | 4.2                               | 4.1     |
| <i>Total gross investment income</i>   | <b>20.9</b>                        | 19.9    | <b>68.2</b>                       | 62.2    |
| Less: Investment expenses              | <b>0.6</b>                         | 0.6     | <b>1.7</b>                        | 1.6     |
| <i>Net investment income</i>           | <b>\$ 20.3</b>                     | 19.3    | <b>\$ 66.5</b>                    | 60.6    |
| Average invested assets (at cost)      | <b>\$ 2,425.4</b>                  | 2,252.8 | <b>\$ 2,403.4</b>                 | 2,220.6 |
| Annualized investment yield            | <b>3.3%</b>                        | 3.4     | <b>3.7%</b>                       | 3.6     |
| Annualized investment yield, after tax | <b>2.7%</b>                        | 2.8     | <b>2.9%</b>                       | 3.0     |
| Net investment income, after tax       | <b>\$ 16.4</b>                     | 15.8    | <b>\$ 52.1</b>                    | 49.5    |
| Effective tax rate                     | <b>19.0%</b>                       | 17.8    | <b>21.6%</b>                      | 18.4    |

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Net investment income for the three and nine months ended September 30, 2011 increased by \$1.0 million and \$5.9 million, respectively, when compared to the same 2010 periods. The results of our net investment income were primarily driven by the amortized cost value of our Treasury Inflation-Protected Securities ( TIPS ), which increased to \$236.1 million at September 30,

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2011, from \$152.0 million at September 30, 2010. For the three and nine months ended September 30, 2011, income earned on our TIPS, which is dependent on changes in the CPI Index, was \$1.8 million and \$9.4 million, respectively, an increase of \$1.2 million and \$6.4 million, respectively, when compared to the same 2010 periods.

The following table sets forth realized gains and the proceeds received on sale for our investment portfolio for the three and nine months ended September 30, 2011:

| (\$ millions)                            | Three months ended<br>September 30, 2011 |                                 | Nine months ended<br>September 30, 2011 |                                 |
|--|--|---------------------------------|---|---------------------------------|
|  | Realized<br>gains<br>(losses)            | Proceeds<br>received<br>on sale | Realized<br>gains<br>(losses)           | Proceeds<br>received<br>on sale |
| <b>Realized gains:</b>                   |  |                                 |   |                                 |
| Fixed maturities                         | \$ 1.1                                   | 37.3                            | \$ 2.9                                  | 107.5                           |
| Equity securities                        | 13.7                                     | 47.3                            | 31.4                                    | 110.1                           |
| Other invested assets                    | 2.1                                      | 10.2                            | 2.1                                     | 10.2                            |
| <i>Total realized gains</i>              | <b>16.9</b>                              | <b>94.8</b>                     | <b>36.4</b>                             | <b>227.8</b>                    |
| <b>Realized losses:</b>                  |  |                                 |   |                                 |
| Fixed maturities                         |  |                                 |   |                                 |
| Sales                                    |  |                                 |   |                                 |
| Equity securities:                       |  |                                 |   |                                 |
| Sales                                    | (2.3)                                    | 6.3                             | (5.3)                                   | 26.0                            |
| OTTI                                     | (4.4)                                    |                                 | (5.3)                                   |                                 |
| <i>Total realized losses</i>             | <b>(6.7)</b>                             | <b>6.3</b>                      | <b>(10.6)</b>                           | <b>26.0</b>                     |
| <i>Net realized gains on investments</i> | <b>\$ 10.2</b>                           | <b>101.1</b>                    | <b>\$ 25.8</b>                          | <b>253.8</b>                    |

During the nine months of 2011, equity sales were executed for various reasons, including: (i) in response to negative outlook announcements or changes in business conditions which in our opinion diminished the future business prospects of certain securities, (ii) in response to achievement of our price target for certain securities, and (iii) in order to position our equity holdings in line with our investment policy.

When a fixed maturity security has been determined to have an other-than-temporary decline in fair value, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income (loss). See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Investments included in Item 7 of the 2010 Form 10-K for other-than-temporary impairment ( OTTI ) indicators. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income (loss). We did not recognize OTTI on our fixed maturity portfolio for the three and nine months ended September 30, 2011 and 2010.

When an equity security or other invested asset has been determined to have a decline in fair value that is other-than-temporary, we adjust the cost basis of the security to fair value. See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Investments included in Item 7 of the 2010 Form 10-K for OTTI impairment indicators. This results in a charge to earnings

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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).

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The following table sets forth the realized losses related to OTTI on our investment portfolio recognized for the three and nine months ended September 30, 2011:

| (\$ millions, except # of positions) | Three months ended<br>September 30, 2011 |                     | Nine months ended<br>September 30, 2011 |                     |
|--------------------------------------|--|---------------------|---|---------------------|
|                                      | Number of<br>positions                   | Total<br>impairment | Number of<br>positions                  | Total<br>impairment |
| <b>Equity securities:</b>            |  |                     |   |                     |
| Large-cap securities                 | 1  | \$ (0.2)            | 1                                       | \$ (0.2)            |
| Small-cap securities                 | 37                                       | (4.2)               | 54                                      | (5.1)               |
| <i>Total OTTI</i>                    | 38                                       | \$ (4.4)            | 55                                      | \$ (5.3)            |

*Gross Unrealized Investment Gains and Losses*

Based upon our review of our investment portfolio at September 30, 2011, we determined that there were no individual investments with an unrealized holding loss that had a fair value significantly below cost continually for more than one year. The following table sets forth detailed information on our available-for-sale investment portfolio by lot at fair value for our gross unrealized holding gains (losses) at September 30, 2011:

| (\$ millions, except # of positions)                                    | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>holding<br>gains | Number<br>of<br>gain<br>positions | Gross<br>unrealized<br>holding<br>losses | Number<br>of<br>loss<br>positions | Fair<br>value |
|---|------------------------------|---|-----------------------------------|--|-----------------------------------|---------------|
| <b>Fixed maturities:</b>  |                              |   |                                   |  |                                   |               |
| U.S. treasury securities and obligations of<br>U.S. government agencies | \$ 478.6                     | \$ 30.1                                 | 106                               | \$ (0.1)                                 | 4                                 | \$ 508.6      |
| Obligations of states and political subdivisions                        | 812.0                        | 44.9                                    | 367                               |  | 3                                 | 856.9         |
| Corporate securities  | 240.5                        | 11.9                                    | 80                                | (0.6)                                    | 14                                | 251.8         |
| U.S. government agencies residential<br>mortgage-backed securities      | 405.0                        | 19.5                                    | 129                               | (0.7)                                    | 17                                | 423.8         |
| <i>Total fixed maturities</i>   | 1,936.1                      | 106.4                                   | 682                               | (1.4)                                    | 38                                | 2,041.1       |
| <b>Equity securities:</b>   |                              |   |                                   |  |                                   |               |
| Large-cap securities  | 138.6                        | 14.2                                    | 33                                | (9.9)                                    | 24                                | 142.9         |
| Small-cap securities  | 34.9                         | 4.6                                     | 69                                |  |                                   | 39.5          |
| <i>Total equity securities</i>  | 173.5                        | 18.8                                    | 102                               | (9.9)                                    | 24                                | 182.4         |
| Other invested assets   | 56.7                         | 8.6                                     | 2                                 |  | 1                                 | 65.3          |

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|   |                   |                 |            |                  |           |                   |
|---|-------------------|-----------------|------------|------------------|-----------|-------------------|
| <i>Total available-for-sale investments</i> | <b>\$ 2,166.3</b> | <b>\$ 133.8</b> | <b>786</b> | <b>\$ (11.3)</b> | <b>63</b> | <b>\$ 2,288.8</b> |
|---|-------------------|-----------------|------------|------------------|-----------|-------------------|

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth our unrealized holding gains (losses) by investment type, net of deferred tax that was included as a component of accumulated comprehensive income (loss) at September 30, 2011 and December 31, 2010, and the change in unrealized holding gains (losses), net of deferred tax, for the nine months ended September 30, 2011:

| <i>(\$ millions)</i>                          | <b>September 30,<br/>2011</b> | December 31,<br>2010 | \$<br>Change |
|---|-------------------------------|----------------------|--------------|
| <b><u>Available-for-sale investments:</u></b> |                               |                      |              |
| Unrealized holding gains:                     |                               |                      |              |
| Fixed maturities                              | \$ 105.0                      | 38.4                 | 66.6         |
| Equity securities                             | 8.9                           | 56.0                 | (47.1)       |
| Other invested assets                         | 8.6                           | 15.3                 | (6.7)        |
| <i>Unrealized gains</i>                       | <b>122.5</b>                  | 109.7                | 12.8         |
| Deferred federal income tax liability         | <b>(42.9)</b>                 | (38.4)               | (4.5)        |
| <i>Unrealized gains, net of tax</i>           | <b>\$ 79.6</b>                | 71.3                 | 8.3          |

**Fair Value Measurements**

We primarily use one independent nationally recognized pricing service in developing fair value estimates. We obtain one price per security, and our processes and control procedures are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, we gain an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, we compare to other fair value pricing information gathered from other independent pricing sources. See Note 3, Fair Value of Financial Instruments to our condensed consolidated financial statements included in Item 1 of this Form 10-Q for a presentation of our available-for-sale investments within the fair value hierarchy at September 30, 2011 and December 31, 2010.

As of September 30, 2011, Level 3 assets as a percentage of total assets were 0.1% which we have determined to be insignificant.

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**Other Items***Income Taxes*

Deferred income tax assets and liabilities represent the tax effect of the differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. In accordance with the Financial Accounting Standards Board's Accounting Standards Codification 740, Income Taxes (ASC 740), we periodically evaluate our deferred tax assets, which requires significant judgment, to determine if they are realizable based upon weighing all available evidence, both positive and negative, including our historical and anticipated future taxable income. In making such judgments, significant weight is given to evidence that can be objectively verified. At September 30, 2011, our net deferred tax asset, excluding the valuation allowance, totaled \$144.3 million compared to \$86.3 million at December 31, 2010. The increase in the September 30, 2011 balance primarily related to the net operating loss carry-forward reflecting the impact of storm losses for the nine months ended September 30, 2011. The magnitude of our second quarter catastrophe losses from unprecedented storms experienced industry wide, which by far exceeded our projections, has resulted in an expectation that we will report a pre-tax loss in 2011 and have a taxable loss for the year. We considered both positive and negative evidence and concluded that a valuation allowance of \$115.0 million should be established at June 30, 2011. The valuation allowance increased to \$143.8 million at September 30, 2011. Total tax expense for the three and nine months ended September 30, 2011 included \$28.9 million and \$143.8 million, respectively, related to the change in the valuation allowance for such periods. The following table sets forth, the components of our federal income tax expense for the three and nine months ended September 30, 2011.

| <i>(\$ millions)</i>             | <b>Three Months Ended<br/>September 30<br/>2011</b> | <b>Nine Months Ended<br/>September 30<br/>2011</b> |
|----------------------------------|---|--|
| Loss before federal income taxes | \$ (52.0)   | \$ (174.2)   |
| Current tax benefit              | 0.3   | (6.4)  |
| Deferred tax benefit             | (22.5)  | (64.2)   |
|                                  | (22.2)  | (70.6)   |
| Valuation allowance              | 28.9  | 143.8  |
| Total Federal income tax expense | 6.7   | 73.2   |
| Net loss                         | \$ (58.7)   | \$ (247.4)   |

In future periods we will re-assess our judgments and assumptions regarding the realization of our net deferred tax assets, but until such time the positive evidence exceeds the negative evidence we will maintain a valuation allowance against our net deferred tax assets. Until that time, as we report net earnings and generate taxable income, we do not expect our consolidated statement of income to reflect any federal income tax expense as we utilize our net operating loss carry-forward and release a corresponding amount of the net deferred tax asset valuation allowance, unless we are in an exception position as described by ASC 740. ASC 740 requires all sources of other income, including other comprehensive income, to be considered when there is an expected loss from continuing operations for purposes of determining the amount of tax benefit that results from a loss from continuing operations and that should be allocated to continuing operations when assessing the realizability of deferred tax assets. Alternatively, any reported



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losses will add to our net operating loss carry-forward position and be reserved against by adding to the net deferred tax asset valuation allowance. See Note 7 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

**LIQUIDITY AND CAPITAL RESOURCES**

**General**

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

**Liquidity**

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

As described above, under the normal Pooling Arrangement procedures, STFC Pooled Companies settle their quarterly activity with State Auto Mutual within 45 days following each quarter. However, due to the unprecedented level of catastrophe loss activity in the second quarter of 2011, significant claim payment activity made by State Auto Mutual continued into the third quarter of 2011. The STFC Pooled Companies paid State Auto Mutual their share of catastrophe losses during the quarter as claims were paid by State Auto Mutual. This early settlement amounted to \$32.1 million.

Despite the significant levels of catastrophe losses paid in 2011, we managed our cash flows through current operational activity and maturities of investments, without the need to liquidate investments. However, should our written premium decline or paid losses increase significantly, or a combination thereof, our cash flows from operations could be impacted, requiring us to liquidate investments at a loss.



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We maintain a portion of our investment portfolio in relatively short-term and highly liquid investments to ensure the immediate availability of funds to pay claims and expenses. At September 30, 2011 and December 31, 2010, we had \$186.7 million and \$88.3 million, respectively, in cash and cash equivalents, and \$2,288.8 million and \$2,236.6 million, respectively, of total available-for-sale investments. Included in our fixed maturities available-for-sale are \$79.7 million and \$72.2 million, respectively, of securities on deposit with insurance regulators as required by law at September 30, 2011 and December 31, 2010. In addition, substantially all of our fixed maturity and equity securities are traded on public markets. For a further discussion regarding investments, see Investments Operations Segment included in this Item 2.

Net cash provided by operating activities was \$34.4 million for the first nine months of 2011, which included a cash inflow of \$69.1 million from the Rockhill Insurers related to the 2011 pooling change.

Our net loss for the nine months ended September 30, 2011 include a non-cash charge of \$143.8 million to establish a valuation allowance against our net deferred tax asset, which did not impact our cash flows from operations.

Net cash provided by investing activities was \$80.4 million for the first nine months of 2011, compared to net cash used in investing activities of \$73.6 million. As funds become available we are holding higher levels of cash in anticipation of a pooling change.

**Capital Position**

At September 30, 2011 our stockholders' equity was \$601.2 million, as compared to \$851.8 million at December 31, 2010. This decline was the result of our previously discussed second and third quarter 2011 losses primarily caused by weather-related catastrophes and the establishment of a valuation allowance against our net deferred tax assets. The statutory capital levels of our insurance subsidiaries were likewise impacted by these events. At September 30, 2011, the statutory surplus of our insurance subsidiaries was \$472.9 million, as compared to \$783.0 million at December 31, 2010.

The net premiums written to surplus ratio, also called the leverage ratio, is a SAP ratio designed to measure the ability of an insurer to absorb losses. The leverage ratio is calculated by dividing the net statutory premiums written for a rolling 12-month period by the ending statutory surplus for the period. For example, a leverage ratio of 1.5 means that for every dollar of surplus, the insurer wrote \$1.50 in premium. At September 30, 2011, the leverage ratio for our insurance subsidiaries was 3.1, as compared to a leverage ratio of 1.7 at December 31, 2010.

We are taking the following steps to improve our capital position and leverage ratio.

Our Board of Directors has approved proposed changes to the Pooling Arrangement. The proposed changes are to be effective December 31, 2011, and include changing the overall participation percentages of the STFC Pooled Companies and the Mutual Pooled Companies to 65% and 35%, respectively, from their current percentages of 80% and 20%, respectively. These proposed changes are to be effective December 31, 2011, and are subject to regulatory approval by various departments of insurance. The proposed changes will improve the leverage ratio of our insurance subsidiaries. If approved, and in conjunction with these changes, the STFC Pooled Companies will transfer net assets (cash and/or investment securities) of approximately \$275.0 million to \$325.0 million to the Mutual Pooled Companies for the net liabilities transferred. The transfer is not expected to have a material impact on our stockholders' equity or book value per share.

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The following table sets forth, on a pro forma basis, for the nine months ended September 30, 2011, the statement of income before federal income taxes, as if the STFC Pooled Companies pooling participation percentage for earned premiums, losses and loss expenses and certain acquisition and operating expenses had been 65%. Additionally, the pro forma presentation reflects the impact of the reduced pooling percent on average invested assets, which was assumed to be approximately \$300.0 million at an assumed annual investment yield of 3.7%:

| (\$ millions)                           | Nine months ended<br>September 30 |                   |
|---|-----------------------------------|-------------------|
|   | 2011<br>As reported               | 2011<br>Pro Forma |
| Earned premiums                         | \$ 1,059.4                        | \$ 860.7          |
| Net investment income                   | 66.5                              | 58.1              |
| Net realized gain on investments        | 24.9                              | 24.9              |
| Other income                            | 1.8                               | 1.8               |
| <b>Total revenues</b>                   | <b>1,152.6</b>                    | <b>945.5</b>      |
| Losses and loss expenses                | 959.5                             | 780.1             |
| Acquisition and operating expenses      | 355.6                             | 290.5             |
| Interest expense                        | 5.4                               | 5.4               |
| Other expenses                          | 6.3                               | 6.3               |
| <b>Total expenses</b>                   | <b>1,326.8</b>                    | <b>1,082.3</b>    |
| <b>Loss before federal income taxes</b> | <b>\$ (174.2)</b>                 | <b>\$ (136.8)</b> |
| GAAP combined ratio:                    |                                   |                   |
| Expense ratio                           | 90.6%                             | 90.6%             |
| Loss and LAE ratio                      | 33.6%                             | 33.7%             |
| Combined ratio                          | 124.2%                            | 124.3%            |

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We have amended our postretirement health care benefit plan to change eligibility requirements for participation of our employees and certain retirees in this plan. We believe this change will allow us to better manage our overall costs while addressing volatility on our balance sheet. As of September 30, 2011, on a pro forma basis, the estimated pre-tax incremental effect of this change on the condensed consolidated balance sheet would have increased stockholders' equity by approximately \$100.0 million, which includes an estimated pre-tax curtailment gain of approximately \$80.0 million.

To further reduce risk and volatility, we plan to put in place by year end a quota share or similar reinsurance solution ceding a significant position of our homeowners business, possibly for a two to three year period. This action will provide us with additional time to complete the aggressive actions we are taking to achieve homeowners' profitability. We believe this action will improve our capital position by reducing leverage and increasing our statutory surplus while providing additional catastrophe protection. Although we believe such a reinsurance agreement is likely, there is no certainty that this will be finalized by December 31, 2011.

**Borrowing Arrangements**

*Credit Agreement*

On September 29, 2011, State Auto Financial terminated its then-current credit agreement and entered into a new credit facility (the "Credit Facility") with a syndicate of lenders. The Credit Facility provides us with a \$100.0 million five-year unsecured revolving credit facility maturing in September 2016. During the term of the Credit Facility, we have the right to increase the total facility to a maximum amount of \$150.0 million, provided that no event of default has occurred and is continuing. The Credit Facility is available for general corporate purposes and provides for interest-only payments during its term, with principal and interest due in full at maturity. Interest is based on a LIBOR or a base rate plus a calculated margin amount. The Credit Facility includes certain covenants, including financial covenants that require us to maintain a minimum net worth and not exceed a certain debt to capitalization ratio. As of September 30, 2011, State Auto Financial had not made any borrowings and was in compliance with all of its covenants.

*Senior Notes*

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

*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, 2011 and 2010 were 4.5% and 4.5%, respectively.

**Reinsurance Arrangements**

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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

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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, 2011 our property catastrophe program, which excludes the Rockhill unit in our specialty insurance segment, was revised. Under the revised reinsurance program, we retain the first \$55.0 million of catastrophe loss, each occurrence, with a 5% co-participation on the next \$160.0 million (previously \$110.0 million) of covered loss, each occurrence. The reinsurers are responsible for 95% of the excess over \$55.0 million up to \$215.0 million of covered losses, each occurrence. We are responsible for losses above \$215.0 million. Our decision to add \$50.0 million of coverage was based upon our growth in the Southwest and Northeast regions, new evaluations of our catastrophe exposures as measured by updated industry catastrophe models and consideration of our own internal risk guidelines.

Our Rockhill unit maintains a property catastrophe excess of loss reinsurance agreement, which was revised as of June 1, 2011 to provide that we retain the first \$7.5 million (previously \$5.0 million) of catastrophe loss, each occurrence, and the reinsurers are responsible for 100% of the excess over \$7.5 million up to \$85.0 million (previously \$80.0 million) of covered loss, each occurrence.

We also revised the State Auto Group's excess of loss reinsurance program for workers' compensation, which is written through our specialty insurance segment, by reducing our retention from \$2.0 million to \$1.0 million of covered loss and extending the reinsurer's liability for the excess over \$1.0 million (previously \$2.0 million) up to \$10.0 million.

For certain casualty lines written through the Rockhill unit, we revised Rockhill's consolidated casualty treaty as of April 1, 2011 to provide that we retain the first \$1.0 million (previously \$0.5 million) of covered loss and the reinsurers are responsible for 75% of the excess over \$1.0 million up to \$6.0 million per risk. As of June 1, 2011, we revised our reinsurance agreement on certain property lines written through the Rockhill unit from a quota share agreement in which we retained 25% of all covered losses to an excess of loss agreement in which we retain the first \$1.0 million of each covered loss. The reinsurers are responsible for 100% of the excess over \$1.0 million up to \$15.0 million of covered loss.

As of May 1, 2011, the Rockhill unit terminated its quota share arrangement for its tow truck program due to the 2011 pooling change and the program's low limits (primarily under \$1 million). For this program Rockhill ceded 25% of the property coverage and 50% of the liability coverage under the quota share arrangement.

Historically, the State Auto Group's reliance on ceded reinsurance is not significant in comparison to the State Auto Group's total statutory surplus or our total financial position. To minimize the risk of reinsurer default, the State Auto Group cedes only to third-party reinsurers who are rated A- or better by A.M. Best and also utilizes both domestic and international markets to diversify its credit risk. We utilize reinsurance to limit our loss exposure and contribute to our liquidity and capital resources. See also the Liquidity and Capital Resources - Capital Position section in this Item for additional information regarding potential changes to our reinsurance agreements.

Except as described in the preceding paragraphs, there have been no material changes in our reinsurance arrangements since December 31, 2010. 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 2010 Form 10-K.

**Credit and Financial Strength Ratings**

On November 9, 2011, Standard & Poor's announced that it was lowering its credit rating on State Auto Financial from BBB- to BB+ and its financial strength rating on the operating insurance companies of the State Auto Group from A- to BBB+ primarily because of the State Auto Group's decline in capital adequacy from historical levels, among other factors, and placed the ratings on CreditWatch with negative

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implications.

In the second quarter 2011, A.M. Best Co. revised the financial strength rating of the State Auto Group to A (Excellent) from A+ (Superior) and its issuer credit rating to a+ from aa-. A.M. Best Co. cited the reasoning for these downgrades as the State Auto Group's deterioration in underwriting and operating earnings in recent years, driven by an increased frequency and severity of property catastrophe losses.

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**ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS**

*Improving Disclosures about Fair Value Measurements*

In January 2010, the Financial Accounting Standards Board ( FASB ) issued guidance to improve the disclosures related to fair value measurements. The guidance requires the information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements to be presented separately on a gross basis, rather than as one net number. We adopted this guidance effective January 1, 2011. The disclosures required by this guidance are provided in Note 3 of the accompanying condensed consolidated financial statements.

*Pending Adoption of Accounting Pronouncements*

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

In October 2010, the FASB issued updated guidance to address diversity in practice for the accounting of costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. The guidance is effective on a prospective basis for fiscal years beginning after December 15, 2011, with early adoption permitted. Retrospective application is also permitted, but not required. We are still assessing the impact the provisions of the new guidance will have on our consolidated financial statements.

*Comprehensive Income*

In June 2011, FASB issued updated guidance to improve the presentation of comprehensive income. In this guidance an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Regardless of how an entity chooses to present comprehensive income, the entity is required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The new guidance is effective for fiscal years and interim periods beginning after December 15, 2011, with early adoption permitted. Retrospective application is required.

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

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

*Testing Goodwill for Impairment*

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In September 2011, the FASB issued updated guidance in relation to testing goodwill for impairment. The amendments in the update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment. The more-likely-than-not threshold is defined as having a likelihood of a more than 50 percent. Previous guidance under Topic 350 (Intangibles - Goodwill and Other), required an entity to test goodwill for impairment on an annual basis. Under this updated guidance, the test for impairment should be performed on an annual basis unless an event occurs or circumstances change that

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

**MARKET RISK**

With respect to Market Risk, see the discussion regarding this subject at Management's Discussion and Analysis of Financial Condition and Results of Operations - Investment Operations Segment - Market Risk in Item 7 of the 2010 Form 10-K. There have been no material changes from the information reported regarding Market Risk in the 2010 Form 10-K.

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

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

**Item 4. Controls and Procedures**

**Disclosure Controls and Procedures**

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

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

**Changes in Internal Control over Financial Reporting**

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

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The following describes the significant pending legal proceedings, other than ordinary routine litigation incidental to our business, to which State Auto Financial or any of its subsidiaries is a party or to which any of our property is subject:

In December 2010, a putative class action lawsuit (Kelly vs. State Automobile Mutual Insurance Company, et al.) was filed against State Auto Financial, State Auto P&C and State Auto Mutual in state court in Ohio. In this lawsuit, plaintiffs allege that the defendants have engaged, and continue to engage, in deceptive practices by failing to disclose to plaintiffs the availability, through one or more related companies, of insurance policies providing for identical coverage and service as those policies purchased by plaintiffs but at a lower premium amount. Plaintiffs are seeking class certification and compensatory and punitive damages to be determined by the court and restitution and/or disgorgement of profits derived from plaintiffs and the alleged class. We believe our practices with respect to pricing, quoting and selling our insurance policies are in compliance with all applicable laws, deny any and all liability to plaintiffs or the alleged class, and intend to vigorously defend this lawsuit.

Based on our current understanding and assessment of this case, we do not expect this matter to have a material adverse effect on our results of operations.

*Other* We are involved in a number of lawsuits, and may become involved in other potential litigation, arising in the ordinary course of our business. Generally, our involvement in a lawsuit involves defending third-party claims brought against our insureds in our role as liability insurer or against us as a principal of surety bonds, as well as defending policy coverage claims brought against us or the our business practice. We consider all lawsuits relating to insurance claims in establishing our loss and loss adjustment expense reserves.

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

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

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**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in the 2010 Form 10-K under Part I, Item 1A Risk Factors.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

**Item 5. Other Information**

None.

**Item 6. Exhibits**

| Exhibit No. | Description of Exhibits   |
|-------------|---|
| 10.1        | Executive Change of Control Agreement dated as of October 28, 2011, among State Auto Financial Corporation, State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company and Steven E. English   |
| 10.2        | Executive Change of Control Agreement dated as of October 28, 2011, among State Auto Financial Corporation, State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company and Clyde H. Fitch, Jr. |
| 10.3        | Executive Change of Control Agreement dated as of October 28, 2011, among State Auto Financial Corporation, State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company and James A. Yano       |
| 31.01       | CEO certification required by Section 302 of Sarbanes Oxley Act of 2002   |
| 31.02       | CFO certification required by Section 302 of Sarbanes Oxley Act of 2002   |
| 32.01       | CEO certification required by Section 906 of Sarbanes Oxley Act of 2002   |
| 32.02       | CFO certification required by Section 906 of Sarbanes Oxley Act of 2002   |
| 101.INS     | XBRL Instance Document  |
| 101.SCH     | XBRL Taxonomy Extension Schema Document   |

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|         |  |
|---------|--|
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF | XBRL Taxonomy Definition Linkbase Document             |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

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**SIGNATURE**

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

Date: November 9, 2011

**State Auto Financial Corporation**

/s/ Steven E. English

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