

State Auto Financial CORP  
Form 10-K  
March 08, 2013

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

**FORM 10-K**

x **Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the fiscal year ended December 31, 2012 or**

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

**Commission File Number 000-19289**

**STATE AUTO FINANCIAL CORPORATION**  
**(Exact name of Registrant as specified in its charter)**

**Ohio**  
**(State or other jurisdiction of**  
  
**incorporation or organization)**

**518 East Broad Street, Columbus, Ohio**  
**(Address of principal executive offices)**

**31-1324304**  
**(I.R.S. Employer Identification No.)**

**43215-3976**  
**(Zip Code)**

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

Registrant's telephone number, including area code:

(614) 464-5000

Securities registered pursuant to Section 12(b) of the Act: None

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

Common Shares, without par value

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of June 30, 2012, the last business day of the Registrant's most recently completed second fiscal quarter, the aggregate market value (based on the closing sales price on that date) of the voting stock held by non-affiliates of the Registrant was \$212,461,602.

On February 25, 2013, the Registrant had 40,518,650 Common Shares outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's Proxy Statement relating to the annual meeting of shareholders to be held May 3, 2013 (the 2013 Proxy Statement), which will be filed within 120 days of December 31, 2012, are incorporated by reference into Part III of this Form 10-K.



---

**Index to Annual Report on Form 10-K for the year ended December 31, 2012**

Form 10-K	Item	Description	Page
Part I	1	<u>Business</u>	6
		<u>Executive Officers of the Registrant</u>	16
	1A	<u>Risk Factors</u>	17
	1B	<u>Unresolved Staff Comments</u>	27
	2	<u>Properties</u>	27
	3	<u>Legal Proceedings</u>	27
	4	<u>Mine Safety Disclosures</u>	28
Part II	5	<u>Market for the Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities</u>	29
	6	<u>Selected Consolidated Financial Data</u>	31
	7	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
	7A	<u>Qualitative and Quantitative Disclosures about Market Risk</u>	75
	8	<u>Financial Statements and Supplementary Data</u>	76
		<u>Reports of Independent Registered Public Accounting Firm</u>	76
	9	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosures</u>	121
	9A	<u>Controls and Procedures</u>	121
	9B	<u>Other Information</u>	121
Part III	10	<u>Directors, Executive Officers and Corporate Governance</u>	122
	11	<u>Executive Compensation</u>	122
	12	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	122
	13	<u>Certain Relationships and Related Transactions, and Director Independence</u>	123
	14	<u>Principal Accountant Fees and Services</u>	123
Part IV	15	<u>Exhibits and Financial Statement Schedules</u>	123
		<u>Signatures</u>	137

**IMPORTANT INFORMATION REGARDING FORWARD-LOOKING STATEMENTS**

All statements, other than statements of historical facts, included in this Annual Report on Form 10-K (this Form 10-K) of State Auto Financial Corporation (State Auto Financial or STFC) or incorporated herein by reference, including, without limitation, statements regarding State Auto Financial's future financial position, business strategy, budgets, projected costs, goals and plans and objectives of management for future operations, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally can be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, believe or continue or the negative thereof or variations thereon or similar terminology. Forward-looking statements speak only as the date the statements were made. Although State Auto Financial believes that the expectations reflected in forward-looking statements have a reasonable basis, it 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 State Auto Financial's actual results to differ materially from those projected, see Risk Factors in Item 1A of this Form 10-K. Except to the limited extent required by applicable law, State Auto Financial undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**IMPORTANT DEFINED TERMS USED IN THIS FORM 10-K**

**Glossary of Terms for State Auto Financial Corporation and Its Subsidiaries and Affiliates**

State Auto Financial or STFC	Refers to our holding company, State Auto Financial Corporation.
We, us, our or the Company	Refers to STFC and its consolidated subsidiaries, namely State Auto Property & Casualty Insurance Company ( State Auto P&C ), Milbank Insurance Company ( Milbank ), State Auto Insurance Company of Ohio ( SA Ohio ), Stateco Financial Services, Inc. ( Stateco ). STFC s former subsidiary Farmers Casualty Insurance Company ( Farmers ) was merged into State Auto P&C as of the close of business on December 31, 2012. STFC s former subsidiary State Auto National Insurance Company ( SA National ) has been included through December 31, 2010, the date of its sale to a third party.
State Auto Mutual or our parent company	Refers to State Automobile Mutual Insurance Company, which owns approximately 62% of STFC s outstanding common shares. State Auto Mutual also owns Risk Evaluation & Design, LLC ( RED ), which acts as a managing general underwriter exclusively for the benefit of our Pooled Companies.
STFC Pooled Companies	Refers to State Auto P&C, Milbank, SA Ohio, and, from January 1, 2010 through December 31, 2010, SA National.
Mutual Pooled Companies	Refers to State Auto Mutual, and certain subsidiaries and affiliates of State Auto Mutual, namely State Auto Florida Insurance Company ( SA Florida ), State Auto Insurance Company of Wisconsin ( SA Wisconsin ), Meridian Security Insurance Company ( Meridian Security ), Meridian Citizens Mutual Insurance Company ( Meridian Citizens Mutual ), Beacon National Insurance Company ( Beacon National ), Patrons Mutual Insurance Company of Connecticut ( Patrons Mutual ), Litchfield Mutual Fire Insurance Company ( Litchfield ) and, as of January 1, 2011, Rockhill Insurance Company ( RIC ), Plaza Insurance Company ( Plaza ), American Compensation Insurance Company ( American Compensation ) and Bloomington Compensation Insurance Company ( Bloomington Compensation ). At the close of business on December 31, 2012, SA Florida and Beacon National were merged into Meridian Security.
Pooled Companies or our Pooled Companies	Refers to the STFC Pooled Companies and the Mutual Pooled Companies.
MIGI Insurers	Refers to Meridian Security and Meridian Citizens Mutual.
MIGI Companies	Refers to the MIGI Insurers and Meridian Insurance Group, Inc. ( MIGI ).
Patrons Insurance Group or Patrons Group	Refers to Patrons Mutual and Litchfield.
Rockhill Insurance Group	Refers to Rockhill Holding Company, its insurance subsidiaries, namely RIC, Plaza, American Compensation and Bloomington Compensation, and its other non-insurance subsidiaries, including RTW, Inc. ( RTW ), a holding company that owns 100% of American Compensation and Bloomington Compensation.
Rockhill Insurers	Refers to RIC, Plaza, American Compensation and Bloomington Compensation.
State Auto Group	Refers to the Pooled Companies and, through December 31, 2012, Beacon Lloyds Insurance Company, which was dissolved as of the close of business on December 31, 2012.

**Glossary of Selected Insurance and Accounting Terms**

Accident year	The calendar year in which loss events occur, regardless of when the losses are actually reported, booked or paid.
Admitted insurer	An insurer licensed to transact insurance business within a state and subject to comprehensive policy rate, form and market conduct regulation by that state's insurance regulatory authority.
Allocated loss adjustment expenses or ALAE	The costs that can be related to a specific claim, which may include attorney fees, external claims adjusters and investigation costs, among others.
Book value per share	Total common stockholders' equity divided by the number of common shares outstanding.
Catastrophe loss	Loss and ALAE from catastrophes, where catastrophes are defined as a severe loss caused by various natural events, including hurricanes, hailstorms, tornadoes, windstorms, earthquakes, severe winter weather and fires. Our catastrophe losses are those designated by the Insurance Services Office (ISO) Property Claim Services (PCS). PCS defines a catastrophe as an event that causes \$25 million or more in industry insured property losses and affects a significant number of property and casualty policyholders and insurers.
Combined ratio	The sum of the loss and LAE ratio and the expense ratio. A combined ratio under 100% generally indicates an underwriting profit. A combined ratio over 100% generally indicates an underwriting loss.
Debt to capital ratio	The ratio of notes payable to the sum of total stockholders' equity and notes payable.
Deferred acquisition costs or DAC	Expenses that vary with, and are primarily related to, the production of new and renewal insurance business, and are deferred and amortized to achieve a matching of revenues and expenses when reported in financial statements prepared in accordance with GAAP.
Direct written premiums	The amounts charged by an insurer to insureds in exchange for coverages provided in accordance with the terms of an insurance contract. The amounts exclude the impact of all reinsurance premiums, either assumed or ceded.
Duration	A measure of the sensitivity of a financial asset's price to interest rate movements.
Earned premiums or premiums earned	The portion of written premiums that applies to the expired portion of the policy term. Earned premiums are recognized as revenue under both SAP and GAAP.
Excess and surplus lines insurance	Specialized property and liability coverages written by non-admitted insurers. These coverages include exposures that do not fit within normal underwriting patterns, involve a degree of risk that is not commensurate with standard rates and/or policy forms, or are not written by admitted insurers because of general market conditions.
Expense ratio or underwriting expense ratio	For SAP, it is the ratio of (i) the sum of statutory underwriting and miscellaneous expenses incurred offset by miscellaneous income (collectively, underwriting expenses) to (ii) written premiums. For GAAP, it is the ratio of acquisition and operating expenses incurred to earned premiums.
Generally accepted accounting principles or GAAP	Accounting practices used in the United States of America determined by the Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA).
Incurred but not reported reserves or IBNR	Estimated losses and LAE that have been incurred but not yet reported to the insurer. This includes amounts for unreported claims, development on known cases, and re-opened claims.
Loss adjustment expenses or LAE	The expenses of settling claims, including legal and other fees, and the portion of general expenses allocated to claim settlement. LAE is comprised of ALAE and ULAE.





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

---

Loss and LAE ratio or loss ratio	For both SAP and GAAP, it is the ratio of incurred losses and LAE to earned premiums.
Loss reserves	Liabilities established by insurers and reinsurers to reflect the estimated cost of claims incurred that the insurer or reinsurer will ultimately be required to pay in respect of insurance or reinsurance it has written. Reserves are established for losses and for LAE, and consist of case reserves and IBNR reserves.
Managing general underwriter or MGU	An independent insurance professional firm that acts as an intermediary between the insurer and retail agents, much like a wholesaler. MGUs frequently have binding authority to issue insurance policies on behalf of an insurer that fit into the underwriting guidelines provided by that insurer. MGUs typically are compensated by an override commission on the insurance coverages sold by their sub-agents.
National Association of Insurance Commissioners or NAIC	An organization of the insurance commissioners or directors of all 50 states, the District of Columbia and the five U.S. territories organized to promote consistency of regulatory practices and statutory accounting standards throughout the United States.
Net premiums written to surplus ratio or leverage ratio	A SAP calculation which measures statutory surplus available to absorb losses. This ratio is calculated by dividing the net statutory premiums written for a rolling twelve month period by the ending statutory surplus for the period. For example, a ratio of 1.5 means that for every dollar of surplus, the insurer wrote \$1.50 in premiums.
Net written premiums	Direct written premiums plus assumed reinsurance premiums less ceded reinsurance premiums.
Non-admitted insurer or surplus lines carrier	An insurer that is not required to be licensed in a state but is allowed to do business in that state subject to certain regulatory oversight by that state's insurance regulatory authority. Non-admitted insurers are not subject to most of the rate and form regulations imposed on admitted insurers because they write specialized property and liability coverages, also known as excess and surplus lines insurance, which allows them the flexibility to change coverages offered and rates charged without time constraints and financial costs associated with the filing process. As such, these insurers offer an opportunity for coverage for specialized exposures that otherwise might not be insurable.
Retail agent or retail agency	An independent insurance professional who represents, and acts as an intermediary for, admitted insurers, generally recommending, marketing and selling insurance products and services to insurance consumers.
Return on average equity	The percent derived by dividing net income by average total stockholders' equity.
Risk-based capital or RBC	A measure adopted by the NAIC and state regulatory authorities for determining the minimum statutory capital and surplus requirements of insurers. Insurers having total adjusted capital less than that required by the RBC calculation will be subject to varying degrees of regulatory action depending on the level of capital inadequacy.
Standard insurance	Insurance which is typically written by admitted insurers. Our personal and business insurance segments are comprised of standard insurance.
Statutory accounting practices or SAP	The practices and procedures prescribed or permitted by state insurance regulatory authorities in the United States for recording transactions and preparing financial statements.
Statutory surplus	Under SAP, the amount remaining after all liabilities, including loss reserves, are subtracted from all admitted assets. Admitted assets are assets of an insurer prescribed or permitted by a state to be recognized on the balance sheet prepared in accordance with SAP.
Unallocated loss adjustment expenses or ULAE	The costs incurred in settling claims, such as in-house processing costs, which cannot be associated with a specific claim.

Underwriting gain or loss

Under SAP, earned premiums less loss and LAE and underwriting expenses.

Unearned premiums

The portion of written premiums that applies to the unexpired portion of the policy term. Unearned premiums are not recognized as revenues under both SAP and GAAP.

Wholesale broker

An independent insurance professional who offers specialized insurance products and serves as an intermediary between a retail agent and an insurer, while typically having no contact with the insured. A wholesale broker may represent both admitted and non-admitted insurers, and may offer both standard and excess and surplus lines insurance.

---

**PART I**

**Item 1. Business**

State Auto Financial is an Ohio domiciled property and casualty insurance holding company incorporated in 1990. We are engaged in writing personal, business and specialty insurance. State Auto Financial's principal subsidiaries are State Auto P&C, Milbank and SA Ohio, each of which is a property and casualty insurance company, and Stateco, which provides investment management services to affiliated insurance companies.

Our parent company is State Auto Mutual, an Ohio domiciled mutual property and casualty insurance company organized in 1921. It owns approximately 62% of State Auto Financial's outstanding common shares. State Auto Mutual's other subsidiaries and affiliates include SA Wisconsin, Meridian Security, Meridian Citizens Mutual, Patrons Mutual, Litchfield and the Rockhill Insurers, each of which is a property and casualty insurance company. In 2009, State Auto Mutual acquired the Rockhill Insurance Group. State Auto Mutual and its insurance subsidiaries and affiliates, along with State Auto Financial's insurance subsidiaries, pool their respective insurance business under the Pooling Arrangement, as further described below.

The State Auto Group markets its insurance products throughout the United States primarily through independent agencies, which include retail agencies and wholesale brokers. All of the property and casualty insurance companies in the State Auto Group are admitted insurers, except for RIC, which is a non-admitted insurer. The operations of the State Auto Group are headquartered in Columbus, Ohio.

Our Pooled Companies are rated A (Excellent) by the A.M. Best Company (A.M. Best).

**FINANCIAL INFORMATION ABOUT SEGMENTS**

Since January 1, 2011, our reportable insurance segments have been personal insurance, business insurance and specialty insurance (collectively the insurance segments). These insurance segments are aligned consistent with the reporting lines to our principal operating decision makers. Our Investment operations is also a reportable segment. See a detailed discussion regarding our segments at Item 7 of this Form 10-K Management's Discussion and Analysis of Financial Condition and Results of Operations Overview and Note 14 to our consolidated financial statements included in Item 8 of this Form 10-K.

**PERSONAL AND BUSINESS INSURANCE**

Products offered in our personal and business insurance segments are marketed exclusively through retail agents, but the segments are managed separately from each other due to the differences in the types of customers they serve or products they provide or services they offer.

**Products**

*Personal Insurance*

In our personal insurance segment, we write standard insurance covering personal exposures to individuals. The primary coverages offered are personal auto and homeowners.

*Business Insurance*

In our business insurance segment, we write standard insurance covering small-to-medium sized commercial exposures. We offer a broad range of coverages which include commercial auto, commercial multi-peril, business owners, fire & allied and general liability.

**Marketing**

We market our personal and business insurance through approximately 2,900 retail agencies. We view our retail agents as our primary customers, because they are in a position to recommend either our insurance products or those of a competitor to their customers. We strongly support the independent agency system and believe its maintenance is essential to our present and future success. We continually develop programs and procedures to enhance our agency relationships, including the following: regular travel by senior management and regional office staff to meet with agents, in person, in their home states; training opportunities; and incentives related to profit and growth. In addition, we share the cost of approved advertising with selected agencies.

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

We actively help our agencies develop the professional sales skills of their staffs. Our training programs include both products and sales training conducted in our corporate headquarters. Further, our training programs include disciplined follow-up and coaching for an extended time. Other targeted training sessions are held in our regional headquarters from time to time, as well as in our agents' offices.

We provide our retail agents with defined travel and cash incentives if they achieve certain sales and underwriting profit levels. Further, we recognize our very top agencies measured by consistent profitability, achievement of written premium thresholds and growth as Inner Circle Agencies. Inner Circle Agencies are rewarded with additional incentives.

We have made continuing efforts to use technology to make it easier for our retail agents to do business with us. We offer internet-based (i) rating, (ii) policy application submission, (iii) execution of changes to policies for certain products and (iv) claims submission. In addition, we provide our agents with the opportunity to maintain policyholder records electronically, avoiding the expense of preparing and storing paper records. We believe that, since agents and their customers realize better service and efficiency through automation, they value their relationship with us. Automation can make it easier for an agent to do business with us, which attracts prospective agents and enhances existing agencies relationships with us.

## **Claims**

Our claims division supports our personal and business insurance segments through emphasis on timely investigation of claims, settlement of meritorious claims for equitable amounts, maintenance of adequate case reserves for claims, and control of external claims adjustment expenses. Achievement of these goals supports our marketing efforts by providing agents and policyholders with prompt and effective service.

We employ a specialized claims model that is skills-based which attempts to yield a quality customer experience regardless of the type and severity of the claim. We staff field adjusters in locations where we have size, scale and density of claims whenever possible to control file quality and enhance customer service. We supplement our field staff with independent adjusters and appraisers in areas in which there is not sufficient volume of claims to warrant staff adjusters.

Claim settlement authority levels are established for each adjuster, supervisor and manager based on their level of expertise. Our claims division is responsible for reviewing the claim, obtaining necessary documentation and establishing loss and expense reserves of certain claims. Generally, property or casualty claims estimated to reach \$100,000 or above are sent to specialists for direct handling.

We minimize claim adjusting costs by settling as many claims as possible through our claims staff and, if possible, by settling disputes regarding automobile physical damage, bodily injury and property insurance claims through arbitration or mediation when appropriate. In addition, selected agents have authority to settle small first party claims, which improves claims service.

We have in-house counsel offices to defend and resolve claims which are in litigation. These offices are strategically placed where we have size, scale and density of legal cases to warrant their existence. We also have a list of highly skilled panel counsel we retain for defending our insureds when appropriate.

Our Claims Express Centers allow us to improve claims efficiency and economy by concentrating the handling of smaller, less complex claims in a centralized environment. We provide claim service 24 hours a day, seven days a week, either through associates in our Claims Express Centers, which are located in Des Moines, Iowa and Columbus, Ohio, or for a few overnight hours, through a third party service provider.

## **SPECIALTY INSURANCE**

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. Our specialty insurance products are written through our admitted and non-admitted insurers. Our specialty insurance segment is organized into the following three units:

*Our RED* unit markets and underwrites small-to-medium commercial exposures, offering property and casualty programs for customers with common risk characteristics or coverage requirements. We may also offer alternative forms of risk protection that include various forms of self-insurance or high deductibles, some of which may utilize captive insurance arrangements or risk retention groups. Coverages offered by this unit include commercial auto, workers compensation, general liability and property. We use approved external claim services for claims notification, handling and settlement with centralized management oversight by our home office team.

*Our Rockhill* unit markets and underwrites commercial exposures which have unique insurance requirements, including difficult to place classes of commercial business which may require customized rates and forms, along with customized insurance programs for specialty niche and homogenous groups of exposures. Coverages offered by this unit may include commercial auto, property, bonds (fidelity and surety) and general liability. Our Rockhill unit uses a combination of a dedicated internal claims unit and also approved external claim services for claims notification, handling and settlement with centralized management oversight by our home office team.

*Our Workers Compensation* unit serves the small-to-medium account and association business. This unit has a dedicated internal claims team emphasizing managed care cost containment strategies including focusing on the injured employee's early return to work and cost-effective quality care.

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

As of January 1, 2013, our units within the specialty insurance segment will change from RED, Rockhill and Workers Compensation to Property, Casualty, Workers Compensation and Programs.

## INVESTMENT OPERATIONS

The primary objectives of our investment strategy are to maintain adequate liquidity and capital to meet our responsibilities to policyholders; grow surplus long term to support the growth of our company; provide a consistent level of income; and manage investment risk. Our investment portfolio is managed separately from that of our parent company and its subsidiaries and affiliates, and investment results are not shared through the Pooling Arrangement, as described below. Stateco performs investment management services for both us and our parent company and its subsidiaries and affiliates. Investment policies and guidelines are set for each company through the Investment Committee of its respective Board of Directors.

For additional discussion regarding our investments, including the market risks related to our investment portfolio, see Item 7 of this Form 10-K, Management's Discussion and Analysis of Financial Condition and Results of Operations - Investment Operations Segment.

## POOLING ARRANGEMENT

Our Pooled Companies pool their respective insurance business in accordance with a quota share reinsurance agreement which we refer to as the Pooling Arrangement. In general, 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 a specified portion of premiums, losses and expenses based on each of the Pooled Companies' respective pooling percentages.

In 2011, we made two changes to the Pooling Arrangement. First, as of January 1, 2011, we added the Rockhill Insurers to the pool with a participation percentage of 0.0%. Second, at the close of business on December 31, 2011, the Pooling Arrangement was amended to reduce the overall participation percentage of the STFC Pooled Companies from 80% to 65% and to include the pooling of applicable balance sheet accounts such as accumulated other comprehensive income related to employee benefit plans. See the detailed discussion of our Pooling Arrangement at Item 7 of this Form 10-K, Management's Discussion and Analysis of Financial Condition and Results of Operations - Pooling Arrangement.

## GEOGRAPHIC DISTRIBUTION

The following table sets forth the geographic distribution of our direct written premiums for the year ended December 31, 2012:

State	% of Total
Ohio	11.8%
Texas	8.8
Kentucky	7.3
Indiana	5.2
Tennessee	5.0
Minnesota	4.6
Pennsylvania	3.9
Illinois	3.5
Michigan	3.4
Florida	3.4
Connecticut	3.3
Maryland	3.2
West Virginia	3.1
Arkansas	3.1
All others <sup>(1)</sup>	30.4
<i>Total</i>	100.0%

<sup>(1)</sup> No other single state accounted for 3.0% or more of the total direct written premiums written in 2012.





## MANAGEMENT AGREEMENT

Through various management and cost sharing agreements, State Auto P&C provides employees to perform all organizational, operational and management functions for the State Auto Group while State Auto Mutual provides certain operating facilities, including our corporate headquarters.

Our primary management agreement, which we refer to as the 2005 Management Agreement, has a ten year term and renews for an additional ten-year period unless terminated sooner in accordance with its terms. If the 2005 Management Agreement was terminated for any reason, we would have to relocate our facilities to continue our operations. However, we do not currently anticipate the termination of the 2005 Management Agreement. See [Properties](#) included in Item 2 of this Form 10-K.

## REINSURANCE

Members of the State Auto Group follow the customary industry practice of reinsuring a portion of their exposures and paying to the reinsurers a portion of the premiums received. Insurance is ceded principally to reduce net liability on individual risks or for individual loss occurrences, including catastrophic losses. Although reinsurance does not legally discharge the individual members of the State Auto Group from primary liability for the full amount of limits applicable under their policies, it does make the assuming reinsurer liable to the extent of the reinsurance ceded. See the detailed discussion of our reinsurance arrangements at Item 7 of this Form 10-K, [Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Reinsurance Arrangements](#).

See [Regulation](#) in this Item 1 for a discussion of the Terrorism Acts.

## LOSS RESERVES

We maintain reserves for the eventual payment of losses and LAE for both reported claims and IBNR. Loss reserves are management's best estimate at a given point in time of what we expect to pay to settle all losses incurred as of the end of the accounting period, based on facts, circumstances and historical trends then known. During the loss settlement period, additional facts regarding individual claims may become known, and consequently it often becomes necessary to revise our estimate of the liability. The results of our operations and financial condition could be impacted, perhaps significantly, in the future if the ultimate payments required to settle claims vary from the loss reserves currently recorded.

Loss reserves for reported losses are initially established on either a case-by-case or formula basis depending on the type and circumstances of the loss. The case-by-case reserve amounts are determined based on our reserving practices, which take into account the type of risk, the circumstances surrounding each claim and applicable policy provisions. The formula reserves are based on historical paid loss data for similar claims with provisions for trend changes caused by inflation. Loss reserves for IBNR claims are estimated based on many variables including historical and statistical information, changes in exposure units, inflation, legal developments, storm loss estimates and economic conditions. Case and formula basis loss reserves are reviewed on a regular basis. As new data becomes available, estimates are updated resulting in adjustments to loss reserves. Generally, reported losses initially reserved on a formula basis which have not settled after six months, are case reserved at that time. Although our management uses many resources to calculate loss reserves, there is no precise method for determining the ultimate liability. We do not discount loss reserves for financial statement purposes. For additional information regarding our loss reserves, see Item 7 of this Form 10-K, [Management's Discussion and Analysis of Financial Condition and Results of Operations Loss and LAE](#).

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

The following table sets forth our one-year development information on changes in the loss reserve for the years ended December 31, 2012, 2011 and 2010:

(\$ millions)	Year Ended December 31		
	2012	2011	2010
<b>Beginning of Year:</b>			
Loss and loss expenses payable	<b>\$ 907.1</b>	\$ 893.0	840.2
Less: Reinsurance recoverable on losses and loss expenses payable	<b>25.5</b>	18.8	20.8
<i>Net losses and loss expenses payable<sup>(1)</sup></i>	<b>881.6</b>	874.2	819.4
Impact of pooling change, January 1, 2011 and 2010		124.1	(4.0)
Provision for losses and loss expenses occurring:			
Current year	<b>795.2</b>	1,213.3	954.2
Prior years <sup>(2)</sup>	<b>(16.9)</b>	(33.3)	(64.6)
<b>Total</b>	<b>778.3</b>	1,180.0	889.6
Loss and loss expense payments for claims occurring during:			
Current year	<b>397.2</b>	724.2	543.9
Prior years	<b>334.0</b>	369.1	286.9
<b>Total</b>	<b>731.2</b>	1,093.3	830.8
Impact of pooling change, December 31, 2011		(203.4)	
<b>End of Year:</b>			
Net losses and loss expenses payable	<b>928.7</b>	881.6	874.2
Add: Reinsurance recoverable on losses and loss expenses payable	<b>13.5</b>	25.5	18.8
<i>Losses and loss expenses payable<sup>(3)</sup></i>	<b>\$ 942.2</b>	\$ 907.1	893.0

(1) Includes net amounts assumed from affiliates of \$376.8 million, \$375.8 million, and \$346.2 million at beginning of year 2012, 2011, and 2010, respectively.

(2) This line item shows decreases in the current calendar year in the provision for losses and loss expenses attributable to claims occurring in prior years. See discussion regarding the calendar year developments at Item 7 of this Form 10-K Management's Discussion and Analysis section at Results of Operations Loss and LAE Development.

(3) Includes net amounts assumed from affiliates of \$435.1 million, \$376.8 million, and \$375.8 million at end of year 2012, 2011, and 2010, respectively.

The following table sets forth our development of loss reserves from 2002 through 2012. Net liability for losses and loss expenses payable sets forth the estimated liability for unpaid losses and LAE recorded at the balance sheet date, net of reinsurance recoverable, for each year shown. This liability represents the estimated amount of losses and LAE for claims incurred during the current year or incurred during prior years that are unpaid at the balance sheet date, including IBNR.

The upper section of the table shows the cumulative amounts paid with respect to the previously reported loss reserve as of the end of each succeeding year. For example, through December 31, 2012, we have paid 90.7% of the losses and LAE that had been incurred but not paid, as estimated at December 31, 2002.

The lower portion of the table shows the current estimate of the previously reported loss reserve based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the claims incurred.

The amounts on the cumulative redundancy (deficiency) line represent the aggregate change in the estimates over all prior years. For example, the year end 2002 loss reserve has developed \$11.9 million or 2.0% redundant through December 31, 2012. This \$11.9 million amount has been included in operating results over the ten years and did not have a significant effect on income in any one year.

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

In evaluating the information in the table, it should be noted that each amount includes the effects of all changes in amounts for prior periods. For example, the amount of the redundancy or deficiency evaluated at December 31, 2004, on claims incurred in 2002 includes the cumulative redundancy or deficiency for years 2002, 2003 and 2004. Conditions and trends that have affected the development of the liability in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on this table.

In 2005, the MIGI Insurers were added to the pool and our share of their net liabilities and assets were transferred to us from them. In 2008, Beacon National, the Patrons Insurance Group, State Auto middle market business and voluntary assumed reinsurance from parties affiliated with State Auto Mutual were added to the pool, and accordingly net assets equal to the increase in net liabilities were transferred to us from them. In 2010, SA National and voluntary assumed reinsurance from third parties unaffiliated with the Pooled Companies that was assumed on or after January 1, 2009 by State Auto Mutual were added to the pool, and accordingly net assets equal to the increase in net liabilities were transferred to us from them. As of January 1, 2011, the Rockhill Insurers were added to the pool, and accordingly net assets equal to the increase in net liabilities were transferred to us from them. As of December 31, 2011, the overall participation percentage of the STFC Pooled Companies was reduced from 80% to 65%, and accordingly net assets equal to the decrease in net liabilities were transferred by us to the Mutual Pooled Companies. The amount of the assets transferred along with the reserve liabilities assumed/ceded in, 2005, 2008, 2010 and 2011 has been netted against and has reduced/increased the cumulative amounts paid for years prior to, 2005, 2008, 2010 and 2011, respectively.

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

(\$ millions)	Years Ended December 31										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Net liability for losses and loss expenses payable	\$ 592.1	\$ 628.8	\$ 655.9	\$ 711.3	\$ 661.0	\$ 647.1	\$ 770.0	\$ 819.4	\$ 874.2	\$ 881.6	\$ 928.7
Paid (cumulative) as of:											
One year later	41.2%	36.7%	31.6%	34.9%	34.9%	31.7%	34.9%	35.5%	40.8%	37.9%	
Two years later	60.8%	53.2%	48.4%	51.1%	50.5%	49.4%	53.2%	53.2%	58.2%		
Three years later	71.4%	63.3%	59.9%	60.9%	60.4%	62.6%	62.7%	63.5%			
Four years later	77.3%	70.6%	66.1%	66.0%	67.8%	69.1%	68.5%				
Five years later	82.3%	74.3%	69.2%	70.3%	71.3%	73.7%					
Six years later	85.1%	76.0%	72.3%	72.7%	74.3%						
Seven years later	86.4%	78.4%	73.8%	74.9%							
Eight years later	88.4%	79.6%	75.6%								
Nine years later	89.3%	81.3%									
Ten years later	90.7%										
Net liability re-estimate as of:											
One year later	99.7%	96.5%	93.3%	89.9%	91.7%	95.8%	92.7%	92.1%	96.2%	98.1%	
Two years later	100.6%	93.2%	87.6%	86.4%	90.5%	93.7%	89.5%	89.1%	94.0%		
Three years later	98.8%	91.0%	86.9%	85.6%	88.8%	91.9%	87.9%	87.8%			
Four years later	98.5%	90.6%	86.2%	85.3%	87.4%	90.8%	87.1%				
Five years later	98.8%	89.8%	85.5%	84.7%	86.9%	90.2%					
Six years later	98.4%	89.7%	85.2%	84.4%	86.7%						
Seven years later	98.6%	89.7%	84.4%	84.2%							
Eight years later	98.6%	89.4%	84.2%								
Nine years later	98.1%	89.2%									
Ten years later	98.0%										
Cumulative redundancy (deficiency)	\$ 11.9	\$ 68.0	\$ 103.5	\$ 112.5	\$ 87.9	\$ 63.4	\$ 99.3	\$ 99.9	\$ 52.3	\$ 16.9	
Cumulative redundancy (deficiency)	2.0%	10.8%	15.8%	15.8%	13.3%	9.8%	12.9%	12.2%	6.0%	1.9%	
Gross* liability end of year	\$ 862.4	\$ 934.0	\$ 1,006.4	\$ 1,111.1	\$ 1,032.7	\$ 1,029.9	\$ 1,198.6	\$ 1,293.2	\$ 1,391.4	\$ 1,411.9	\$ 1,435.8
Reinsurance recoverable	\$ 270.3	\$ 305.2	\$ 350.5	\$ 399.8	\$ 371.7	\$ 382.8	\$ 428.6	\$ 473.8	\$ 517.2	\$ 530.3	\$ 507.1
Net liability end of year	\$ 592.1	\$ 628.8	\$ 655.9	\$ 711.3	\$ 661.0	\$ 647.1	\$ 770.0	\$ 819.4	\$ 874.2	\$ 881.6	\$ 928.7
Gross liability re-estimated latest	98.9%	92.3%	88.1%	87.7%	89.6%	93.6%	89.8%	89.7%	97.5%	96.4%	
Reinsurance recoverable re-estimated latest	101.0%	98.6%	95.5%	93.9%	94.8%	99.4%	94.6%	92.9%	103.5%	93.7%	
Net liability re-estimated latest	98.0%	89.2%	84.2%	84.2%	86.7%	90.2%	87.1%	87.8%	94.0%	98.1%	

\* Gross liability includes: Direct and assumed losses and loss expenses payable.

As the Pooling Arrangement provides for the right of offset, we have reported losses and loss expenses payable ceded to our parent company as assets only in situations when net amounts ceded to our parent company exceed that assumed. The following table provides a reconciliation of the reinsurance recoverable to the amount reported in our consolidated financial statements at each balance sheet date:

	December 31										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Reinsurance recoverable	\$ 270.3	\$ 305.2	\$ 350.5	\$ 399.8	\$ 371.7	\$ 382.8	\$ 428.6	\$ 473.8	\$ 517.2	\$ 530.3	\$ 507.1
Amount netted against assumed from State Auto Mutual	\$ 261.5	\$ 291.0	\$ 324.6	\$ 382.4	\$ 358.2	\$ 371.6	\$ 407.4	\$ 453.0	\$ 498.4	\$ 504.8	\$ 493.6
Net reinsurance recoverable	\$ 8.8	\$ 14.2	\$ 25.9	\$ 17.4	\$ 13.5	\$ 11.2	\$ 21.2	\$ 20.8	\$ 18.8	\$ 25.5	\$ 13.5

---

## COMPETITION

The property and casualty insurance industry is highly competitive. We compete with numerous insurance companies, with varying size and financial resources. We compete in the personal and business insurance markets based on the following factors: price; product offerings and innovation; underwriting criteria; quality of service to insureds, relationships with our retail agents and wholesale brokers; prompt and fair claims handling and settlement; financial stability; and technology, making us a preferred business partner. In addition, because most of our retail agents and wholesale brokers represent more than one insurer, we face competition within each agency and broker.

## REGULATION

Most states, including all the domiciliary states of the State Auto Group, have enacted legislation that regulates insurance holding company systems. Each insurance company in our holding company system is required to register with the insurance supervisory agency of its state of domicile and furnish information concerning the operations of companies within our holding company system that may materially affect the operations, management or financial condition of the insurers within the system. Pursuant to these laws, the respective insurance departments may examine any members of the State Auto Group, at any time, require disclosure of material transactions involving insurer members of our holding company system, and require prior notice and an opportunity to disapprove of certain extraordinary transactions, including, but not limited to, extraordinary dividends to shareholders. Pursuant to these laws, all transactions within our holding company system affecting any insurance subsidiary within the State Auto Group must be fair and equitable. In addition, approval of the applicable state insurance commissioner is required prior to the consummation of transactions affecting the control of an insurer. The insurance laws of all the domiciliary states of the State Auto Group provide that no person may acquire direct or indirect control of a domestic insurer without obtaining the prior written approval of the state insurance commissioner for such acquisition.

In addition to being regulated by the insurance department of its state of domicile, each of our insurance companies is subject to supervision and regulation in the states in which we transact business. Such supervision and regulation relate to numerous aspects of an insurance company's business operations and financial condition. The primary purpose of such supervision and regulation is to ensure financial stability of insurance companies for the protection of policyholders. The laws of the various states establish insurance departments with broad regulatory powers relative to granting and revoking licenses to transact business, regulating trade practices, licensing agents, approving policy forms, setting reserve requirements, determining the form and content of required statutory financial statements, prescribing the types and amount of investments permitted and requiring minimum levels of statutory capital and surplus. Although premium rate regulation varies among states and lines of insurance, such regulations generally require approval of the regulatory authority prior to any changes in rates. In addition, all of the states in which the State Auto Group transacts business have enacted laws which restrict these companies' underwriting discretion. Examples of these laws include restrictions on policy terminations, restrictions on agency terminations and laws requiring companies to accept any applicant for automobile insurance. These laws may adversely affect the ability of the insurers in the State Auto Group to earn a profit on their underwriting operations.

We are required to file detailed annual reports with the supervisory agencies in each of the states in which we do business, and our business and accounts are subject to examination by such agencies at any time.

There can be no assurance that such regulatory requirements will not become more stringent in the future and have an adverse effect on the operations of the State Auto Group.

*Dividends.* Our insurance subsidiaries generally are restricted by the insurance laws of our respective states of domicile as to the amount of dividends we may pay without the prior approval of our respective state regulatory authorities. Generally, the maximum dividend that may be paid by an insurance subsidiary during any year without prior regulatory approval is limited to the greater of a stated percentage of that subsidiary's statutory surplus as of a certain date, or adjusted net income of the subsidiary for the preceding year. Under current law, \$62.6 million is available in 2013 for payment as a dividend from our insurance subsidiaries to STFC without prior approval from our respective domiciliary state insurance departments. STFC received dividends of \$20.0 million and \$56.4 million in 2012 and 2011, respectively, from its insurance subsidiaries.

*Rates and Related Regulation.* Except as discussed below, we are not aware of the adoption of any adverse legislation or regulation in any state in which we conducted business during 2012 which would materially impact our business.

Many states in which we operate have passed or are considering legislation restricting or banning the use of credit scoring in the rating and risk selection process. In addition, the Fair and Accurate Credit Transactions Act of 2003 directed certain federal agencies to consider how the use of credit information may affect the availability and affordability of property/casualty insurance and whether credit scoring systems could have a disparate impact on minorities. A 2007 Federal Trade Commission (FTC) report on automobile insurance concluded that credit-based scoring is an effective predictor of risk, but has little effect as an indicator of racial or ethnic status of consumers. Despite these conclusions consumer groups and various government entities continue to resist the use of credit scoring in the rating a risk selection process. In 2008, the FTC asked nine of the largest homeowners insurance companies to provide information to allow the FTC to analyze how consumer credit data is used in underwriting and rate setting. The FTC continues to analyze the information and expects to issue a report in the future. Upon the release of the report the results of the study could affect future use of credit scoring. Banning or restricting this practice or data mining would limit our ability, and the ability of other insurers, to take advantage of the predictive value of this information.

In an attempt to make capital and surplus requirements more accurately reflect the underwriting risk of different lines of insurance, as well as investment risks that attend insurers' operations, the NAIC annually tests insurers' risk-based capital requirements. As of December 31, 2012, each of the Pooled Companies had adequate levels of capital as defined by the NAIC with its respective risk-based capital requirements.

The property and casualty insurance industry is also affected by court decisions. In general, premium rates are actuarially determined to enable an insurance company to generate an underwriting profit. These rates contemplate a certain level of risk. The courts may modify, in a number of ways, the level of risk which insurers had expected to assume, including eliminating exclusions, expanding the terms of the contract, multiplying limits of coverage, creating rights for policyholders not intended to be included in the contract and interpreting applicable statutes expansively to create obligations on insurers not originally considered when the statute was passed. Courts have also undone legal reforms passed by legislatures, which reforms were intended to reduce a litigant's rights of action or amounts recoverable and so reduce the costs borne by the insurance mechanism. These court decisions can adversely affect an insurer's profitability. They also create pressure on rates charged for coverages adversely affected, and this can cause a legislative response resulting in rate suppression that can unfavorably impact an insurer.

The Terrorism Risk Insurance Act of 2002 and its successors, the Terrorism Risk Insurance Extension Act of 2005 and the Terrorism Risk Insurance Program Reauthorization Act of 2007 (collectively, the Terrorism Acts) require the federal government and the insurance industry to share in insured losses up to \$100 billion per year resulting from terrorist attacks within the United States. Under the Terrorism Acts, commercial property and casualty insurers must offer their commercial policyholders coverage against certified acts of terrorism, but the policyholders may choose to reject this coverage (terrorism coverage is mandatory for workers' compensation). If the policyholder rejects coverage for certified acts of terrorism, we will cover only such acts of terrorism that are not certified acts under the Terrorism Acts and continue to apply policy exclusions that may limit any coverage from loss due to nuclear, biological or chemical agents. Our current property reinsurance treaties exclude certified acts of terrorism. The Terrorism Acts are due to expire in December 2014. It is uncertain whether the Terrorism Acts will be extended, revised or allowed to expire. See Risk Factors-Terrorism in Item 1A of this Form 10-K.

The Federal Insurance Office was established in 2010 by the enactment of the Dodd-Frank Act. The Federal Insurance Office is a separate office within the United States Department of Treasury. The primary objective of the Federal Insurance Office is to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system. The Federal Insurance Office also coordinates and develops federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors, assists in negotiating certain international agreements, monitors access to affordable insurance by traditionally underserved communities and consumers, minorities, and low- and moderate-income persons, and assists in the administration of the terrorism risk insurance program. However, the Federal Insurance Office has no authority as a regulator or supervisor of insurance companies.

## **EMPLOYEES**

As of February 25, 2013, we had 2,423 employees. Our employees are not covered by any collective bargaining agreement. We consider the relationship with our employees to be good.

## **AVAILABLE INFORMATION**

Our website address is [www.StateAuto.com](http://www.StateAuto.com). Through this website (found by clicking the Investors link, then the All SEC Filings link), we make available, free of charge, our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, proxy and information statements and all amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act), as soon as reasonably practicable after we electronically file such material with the Securities and Exchange Commission (the SEC). Also available on our website is information pertaining to our corporate governance, including the charters of each of our standing committees of our Board of Directors, our corporate governance guidelines, our employees' code of business conduct and our directors' ethical principles.





Any of the materials we file with the SEC may also be read and copied at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the SEC's Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

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

**Executive Officers of the Registrant**

Name of Executive Officer and Position(s) with Company	Age <sup>(1)</sup>	Principal Occupation(s) During the Past Five Years	An Executive Officer of the Company Since <sup>(2)</sup>
Robert P. Restrepo, Jr., Chairman, President and Chief Executive Officer	62	Chairman of the Board and Chief Executive Officer of STFC and State Auto Mutual, 2/06 to present; President of STFC and State Auto Mutual, 3/06 to present.	2006
Steven E. English, Vice President and Chief Financial Officer	52	Vice President of STFC and State Auto Mutual, 5/06 to present; Chief Financial Officer of STFC and State Auto Mutual, 12/06 to present.	2006
Joel E. Brown, Vice President	55	Vice President, Standard Lines, of STFC and State Auto Mutual, 1/11 to present; Vice President, Personal Lines, and Regional Vice President of STFC and State Auto Mutual, 1/01 to 1/11.	2011
Jessica E. Buss, Vice President, Specialty Lines	41	Vice President, Specialty Lines, of STFC and State Auto Mutual, 1/11 to present; Chief Operating Officer of Rockhill Insurance Company, 11/08 to 1/11; Chief Financial Officer of Rockhill Insurance Company, 11/05 to 11/08.	2011
Clyde H. Fitch, Jr., Senior Vice President and Chief Sales Officer	62	Senior Vice President and Chief Sales Officer of STFC and State Auto Mutual, 11/07 to present.	2007
Stephen P. Hunckler, Vice President and Chief Claims Officer	54	Vice President and Chief Claims Officer of STFC and State Auto Mutual, 8/09 to present; Chief Claims Officer of Balboa Insurance Group 8/06 to 8/09.	2011
Scott A. Jones, Vice President and Chief Investment Officer	48	Vice President and Investment Officer of STFC and State Auto Mutual, 3/12 to present; Assistant Vice President of STFC and State Auto Mutual, 8/09 to 3/12; Portfolio Manager of STFC and State Auto Mutual for more than five years prior to 8/09.	2012
Cynthia A. Powell, Vice President and Chief Risk Officer	52	Chief Risk Officer of STFC and State Auto Mutual, 6/12 to present; Vice President of State Auto Mutual, 3/00 to present; Vice President of STFC, 5/00 to present; Treasurer of STFC and State Auto Mutual, 6/06 to 6/12.	2000
Lorraine M. Siegworth, Vice President	45	Vice President of STFC and State Auto Mutual, 11/06 to present.	2006
James A. Yano, Vice President, Secretary and General Counsel	61	Vice President, Secretary and General Counsel of STFC and State Auto Mutual, 4/07 to present.	2007

(1) Age as of March 8, 2013.

(2) Each of the foregoing officers has been designated by our Board of Directors as an executive officer for purposes of Section 16 of the Exchange Act.



---

## Item 1A. Risk Factors

Statements contained in this Form 10-K may be forward-looking within the meaning of the Section 21E of the Exchange Act. Such forward-looking statements are subject to certain risks and uncertainties that could cause our operating results to differ materially from those projected. The following factors, among others, in some cases have affected, and in the future could affect, our actual financial performance. If any risks or uncertainties discussed below develop into actual events, then such events could have a material adverse effect on our business, liquidity, capital resources, financial position or results of operations. In that case, the market price of our stock could decline materially. The following list of risk factors is not exhaustive and others may exist or develop.

### RESERVES

*If our estimated liability for losses and loss expenses is incorrect, our loss reserves may be inadequate to cover our ultimate liability for losses and loss expenses and may have to be increased.*

We establish loss reserves based on actuarial estimates of the amount to be paid in the future to settle all claims incurred as of the end of the accounting period. We maintain loss reserves to cover our estimated ultimate unpaid liability for losses and loss expenses with respect to reported and unreported claims incurred as of the end of each accounting period. Loss reserves do not represent an exact calculation of the liability, but instead represent estimates, generally using actuarial projection techniques at a given accounting date. Our loss reserve estimates are expectations of what the ultimate settlement and administration of claims will cost based on our assessment of facts and circumstances then known, historical settlement patterns, estimates of trends in claims severity and frequency, legal theories of liability and other factors. Variables in the loss reserve estimation process can be affected by both internal and external events, such as changes in claims handling procedures, trends in loss costs, economic inflation, legal developments and legislative changes. Many of these items are not directly quantifiable, particularly on a prospective basis. Additionally, there may be a significant reporting lag between the occurrence of an insured event and the time a claim is actually reported to the insurer. We refine loss reserve estimates in a regular ongoing process as historical loss experience develops and additional claims are reported and settled. We record adjustments to loss reserves in the results of operations for the periods in which the estimates are changed. In establishing loss reserves, we take into account estimated recoveries for reinsurance, salvage and subrogation.

Because estimating loss reserves is an inherently uncertain process, currently established loss reserves may not be adequate. If we conclude the estimates are incorrect and our loss reserves are inadequate, we are obligated to increase them. An increase in loss reserves results in an increase in losses, reducing our net income for the period in which the deficiency is identified. Accordingly, an increase in loss reserves could have a material adverse effect on our results of operations, liquidity and financial condition.

### CATASTROPHE LOSSES AND GEOGRAPHIC CONCENTRATIONS

*The occurrence of catastrophic events could cause volatility in our results of operations and could materially reduce our level of profitability.*

Our insurance operations expose us to claims arising out of catastrophic events. We have experienced, and will in the future experience, catastrophe losses that may cause substantial volatility in our financial results for any fiscal quarter or year and could materially reduce our level of profitability or harm our financial condition, which in turn could adversely affect our ability to write new business. Catastrophes can be caused by various natural events, including hurricanes, hailstorms, tornadoes, windstorms, earthquakes, severe winter weather and fires, none of which are within our control. Catastrophe losses can vary widely and could significantly impact our results. The frequency and severity of catastrophes are inherently unpredictable. Additionally, catastrophe losses incurred by residual markets or pooling mechanisms (such as wind pools) in certain states could trigger assessments to us. Such assessments could be material and may not be recoupable, depending on the applicable state mechanism.

The magnitude of loss from a catastrophe is a function of the severity of the event and the total amount of insured exposure in the affected area. Accordingly, we can sustain significant losses from less severe catastrophes, such as localized windstorms, when they affect areas where our insured exposure is concentrated. Although catastrophes can cause losses in a variety of our property and casualty lines, most of our catastrophe claims in the past have related to homeowners, allied lines and commercial multi-peril coverages. The geographic distribution of our business subjects us to catastrophe exposure from severe thunderstorms, tornadoes and hail, as well as earthquakes and hurricanes affecting the United States. In the last three years, the largest catastrophe or series of catastrophes affecting STFC's results of operations in any one year were as follows: in 2012, losses related to wind and hail activity from a tornado in March, wind and hail activity in Louisville, Kentucky, and St. Louis, Missouri, in April, and wind activity from a storm in the Midwest and Mid-Atlantic states in June resulted in approximately \$50.5 million in pre-tax losses; in 2011, losses arising from a hurricane, tornadoes, and wind and hail storms, which impacted 32 of our operating states, including Hurricane Irene and devastating tornadoes in Tuscaloosa, Alabama and Joplin, Missouri, which resulted in approximately \$130.6 million in pre-tax losses; and in 2010, losses from a series of spring storms, including wind and hail in northern Ohio, and floods in the Nashville, Tennessee area, both which affected our auto physical damage results in both personal and business insurance auto lines, which resulted in approximately \$22.2 million in pre-tax losses.



Increases in the value and geographic concentration of insured properties and the effects of inflation could increase the severity of claims from catastrophic events in the future. In addition, states have from time to time passed legislation that limits the ability of insurers to manage catastrophe risk, such as legislation prohibiting insurers from withdrawing from catastrophe-prone areas. Although we attempt to reduce the impact of catastrophes on our business by controlling concentrations of exposures in catastrophe prone areas and through the purchase of reinsurance covering various categories of catastrophes, reinsurance may prove inadequate if a major catastrophic loss exceeds the reinsurance limit, or an insurance subsidiary incurs a number of smaller catastrophes that, individually, fall below the reinsurance retention level.

Along with others in the industry, we utilize catastrophe models developed by third party vendors to help assess and manage our exposure to catastrophe losses. Such models assume various conditions and probability scenarios and use historical information about catastrophic events, along with detailed information about our business. There are limitations to the usefulness of such models, and they do not necessarily accurately predict future losses. While we use such modeling information in connection with our pricing and risk management activities, there are limitations with respect to the models' usefulness in predicting losses in any reporting period. Such limitations are evidenced by the occurrence of significant variations in estimates between models and modelers; material increases or decreases in model results due to changes and refinements of the underlying data elements and assumptions; and differences observed between the results of actual event conditions and modeled expectations. Climate change, to the extent it affects changes in weather patterns, could impact the frequency or severity of weather events. Some industry commentators have expressed concerns that hydraulic fracturing or fracking, a process which involves drilling deep underground wells and injecting water, chemicals and sand into the rock formations in order to extract oil and gas, may cause seismic activity which, among other things, may affect the frequency of earthquakes. We view fracking as an emerging risk facing the industry.

Our ongoing catastrophe management efforts could negatively impact growth to the extent constraints on property exposures are deemed necessary in certain territories. In addition, due to the potential impact on cross-selling opportunities, new business growth in the auto lines could be negatively affected.

#### **UNDERWRITING AND PRICING**

*Our financial results depend primarily on our ability to underwrite risks effectively and to charge adequate rates to policyholders.*

Our financial condition, cash flows and results of operations depend on our ability to underwrite and set rates adequately for a full spectrum of risks, across a number of lines of insurance. Rate adequacy is necessary to generate sufficient premium to pay losses, loss adjustment expenses and underwriting expenses and to earn a profit.

Our ability to underwrite and set rates effectively is subject to a number of risks and uncertainties, including, without limitation:

the availability of sufficient, reliable data;

our ability to conduct a complete and accurate analysis of available data;

our ability to timely recognize changes in trends and to project both the severity and frequency of losses with reasonable accuracy;

uncertainties which are generally inherent in estimates and assumptions;

our ability to project changes in certain operating expense levels with reasonable certainty;

the development, selection and application of appropriate rating formulae or other pricing methodologies;

our use of predictive modeling or other underwriting tools to assist with correctly and consistently achieving the intended results in underwriting and pricing;

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

our ability to establish and consistently follow appropriate underwriting guidelines;

our ability to innovate with new pricing strategies, and the success of those innovations on implementation;

our ability to secure regulatory approval of premium rates on an adequate and timely basis and effectively implement such rate changes;

our ability to predict policyholder retention accurately;

unanticipated court decisions, legislation or regulatory action;

unanticipated changes or execution problems in our claim settlement practices;

changing driving patterns and technological innovations in automobiles for auto exposures; changing weather patterns (including those which may be related to climate change) for property exposures;

changes in the medical sector of the economy; including healthcare reform cost shifting and other factors;

unanticipated changes in auto repair costs, auto parts prices and used car prices;

impact of inflation and other factors, such as demand surge on cost of construction materials, labor and other expenditures;

our ability to monitor and manage property concentration in catastrophe prone areas, such as hurricane, earthquake and wind/hail regions; and

the general state of the economy in the states in which we operate.

Such risks may result in our rates being based on inadequate or inaccurate data or inappropriate assumptions or methodologies, and may cause our estimates of future changes in the frequency or severity of claims to be incorrect. As a result, we could underprice risks, which would negatively affect our margins, or we could overprice risks, which could reduce our premium reserves and competitiveness. In either event, our operating results, financial condition and cash flows could be materially adversely affected.

## **DIVIDENDS**

*There can be no assurance that we will continue to pay cash dividends consistent with current or past levels.*

We have a history of consistently paying cash dividends to our shareholders. In the fourth quarter of 2012, the Board of Directors of State Auto Financial reduced the amount of dividends paid on our common shares from \$0.15 per share to \$0.10 per share; however, the future payment of cash dividends will depend upon a variety of factors, such as our results of operations, financial condition and cash requirements, as well as the ability of our insurance subsidiaries to make distributions to STFC. State insurance laws restrict the payment of dividends by insurance companies to their shareholders. In addition, competitive pressures generally require insurance companies to maintain insurance financial strength ratings. Such restrictions and other requirements and factors may affect the ability of our insurance subsidiaries to make dividend payments to STFC. Limits on the ability of our insurance subsidiaries to pay dividends could adversely affect our liquidity, including our ability to pay cash dividends to shareholders.

## **TECHNOLOGY AND TELECOMMUNICATION SYSTEMS**

*Our business success and profitability depend, in part, on effective information technology and telecommunication systems. If we are unable to keep pace with the rapidly developing technological advancements in the insurance industry, our ability to compete effectively could be impaired.*

We depend in large part on our technology and telecommunication systems for conducting business and processing claims. Our business success is dependent on maintaining the effectiveness of existing technology and telecommunication systems and on their continued development and enhancement to support our business processes and strategic initiatives in a cost effective manner. We are developing a new claims system which we expect to implement for most lines of business during 2013. This initiative has involved a significant commitment of resources. This new system is expected to add functionality and increase our claims efficiency with improved file quality; however, this system may not be implemented within the planned time frame or budget, and the expected benefits of this system may not be realized upon implementation.

During 2013, we will begin a multi-year business and technology transition to consolidate all of our policy administration systems. The transition is not expected to be complete for several years. For this initiative, we are partnering with a third party which specializes in providing core system software to the insurance industry. The new technology platform is intended to provide us with quicker speed to market, improve ease of doing business for our policyholders, agents and brokers, lower our costs for maintenance and product introductions and provide greater operational efficiency. However, even with our best planning and efforts and the involvement of third party expertise, there can be no assurance that the expected benefits will be realized upon implementation or that the transition will be completed within the planned time frame or budget.

An ongoing challenge during system development and enhancement is the effective and efficient utilization of our current technology in view of a constantly changing technological landscape. There can be no assurance that the development of current technology for future use will not result in our being competitively disadvantaged, especially with those carriers that have greater resources. If we are unable to keep pace with the advancements being made in technology, our ability to compete with other insurance companies who have advanced technological capabilities will be negatively affected. Further, if we are unable to effectively execute and update or replace our key legacy technology and telecommunication systems as they become obsolete or as emerging technology renders them competitively inefficient, our competitive position and/or cost structure could be adversely affected.

## **BUSINESS CONTINUITY**



***Our business depends on the uninterrupted operation of our facilities, systems and business functions, including our information technology, telecommunications and other business systems. Our business continuity and disaster recovery plans may not sufficiently address all contingencies.***

Our business is highly dependent upon our ability to execute, in an efficient and uninterrupted fashion, necessary business functions, such as Internet support and 24-hour claims contact centers, processing new and renewal business, receiving and processing payment receipts and processing and paying claims. A shut-down of or inability to access one or more of our facilities, power outages, a major failure of the Internet, a pandemic, or a failure of one or more of our information technology, telecommunications or

other systems could significantly impair our ability to perform such functions on a timely basis. In addition, because our information technology and telecommunications systems interface with and depend on third party systems, we could experience service denials if demand for such service exceeds capacity, or if our system or a third party system fails or experiences an interruption. If sustained or repeated, such a business interruption, systems failure or service denial could result in a deterioration of our ability to write and process new and renewal business, provide customer service, receive premium payments, pay claims in a timely manner or perform other necessary corporate functions. This could result in a materially adverse effect on our business results and liquidity and may cause reputational damage.

We have established a business continuity plan that is designed to continue our core business operations in the event that normal business operations cannot be performed due to a catastrophic event. While we continue to test and assess our business continuity plan to meet the needs of our core business operations and addresses multiple business interruption events, there is no assurance that we will be able to perform our core business operations upon the occurrence of such an event, which may result in a material adverse effect on our financial position and results of operations.

#### **CYBER-SECURITY THREATS**

*Our highly automated and networked organization is subject to cyber-terrorism and a variety of other cyber-security threats. These threats come in a variety of forms, such as viruses and malicious software. Such threats can be difficult to prevent or detect, and if experienced, could interrupt or damage our operations, harm our reputation or have a material effect on our operations.*

Our technology and telecommunications systems are highly integrated and connected with other networks. Cyber-attacks involving these systems could be carried out remotely and from multiple sources and could interrupt, damage or otherwise adversely affect the operations of these critical systems. Cyber-attacks could result in the modification or theft of data, the distribution of false information or the denial of service to users. We obtain, utilize and maintain data concerning individuals and organizations with which we have a business relationship. Threats to data security can emerge and change in rapid fashion, resulting in the ongoing need to expend resources to secure our data in accordance with customer expectations and statutory and regulatory requirements.

We could be subject to liability if confidential customer information is misappropriated from our technology systems. Despite the implementation of security measures, these systems may be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. Any well-publicized compromise of security could deter people from entering into transactions that involve transmitting confidential information to our systems, which could have a material adverse effect on our business and reputation.

We rely on services and products provided by many vendors. In the event that one or more of our vendors fails to protect personal information of our customers, claimants or employees, we may incur operational impairments, or could be exposed to litigation, compliance costs or reputational damage.

While we have not experienced material cyber-incidents to date, the occurrence and effects of cyber-incidents may remain undetected for an extended period. During 2012, we purchased cyber-liability insurance coverage. Such coverage addresses certain potential losses such as liability to others, costs of related crisis management, data extortion, applicable forensics and certain regulatory defense costs, fines and penalties.

#### **REINSURANCE**

*Reinsurance may not be available, collectible or adequate to protect us against losses, or may cause us to constrain the amount of business we underwrite in certain lines of business and locations.*

We use reinsurance to help manage our exposure to insurance risks and to manage our capital. The availability and cost of reinsurance are subject to prevailing market conditions, which can affect our business volume and profitability. Although the reinsurer is liable to us to the extent of the ceded reinsurance, we remain liable as the direct insurer on all risks reinsured. Ceded reinsurance arrangements do not eliminate our obligation to pay claims. As a result, we are subject to counterparty risk with respect to our ability to recover amounts due from reinsurers. Reinsurance may not be adequate to protect us against losses and may not be available to us in the future at commercially reasonable rates. In addition, the magnitude of losses in the reinsurance industry resulting from catastrophes may adversely affect the financial strength of certain reinsurers, which may result in our inability to collect or recover reinsurance. Reinsurers also may reserve their right to dispute coverage with respect to specific claims. With respect to catastrophic or other loss, if we experience difficulty collecting from reinsurers or obtaining additional reinsurance in the future, we will bear a greater portion of the total financial responsibility for such loss, which could materially reduce our profitability or harm our financial condition.

As described in more detail elsewhere in this Form 10-K, we have entered into a quota share reinsurance agreement covering our homeowners line of business. Under this agreement, 75% of our homeowners premium revenues, losses and ALAE are ceded to third party reinsurers. The

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

reduction in net written premiums may put pressure on our expense ratios with respect to underwriting expenses and ULAE. Consistent with our homeowners profitability plans, we expect to constrain homeowners policy count growth in certain states with geographic concentrations and/or unsatisfactory underwriting results.

## **CYCLICAL NATURE OF THE INDUSTRY**

*The property and casualty insurance industry is highly cyclical, which may cause fluctuations in our operating results.*

The property and casualty insurance industry, particularly business insurance, has been historically characterized by periods of intense price competition due to excess underwriting capacity, as well as periods of shortages of underwriting capacity that result in higher prices and more restrictive contract and/or coverage terms. The periods of intense price competition may adversely affect our operating results, and the overall cyclical nature of the industry may cause fluctuations in our operating results. While we may adjust prices during periods of intense competition, it remains our strategy to allow for acceptable profit levels and to decline coverage in situations where pricing or risk would not result in acceptable returns. Accordingly, our commercial and specialty lines of business tend to contract during periods of severe competition and price declines and expand when market pricing allows an acceptable return. This can cause volatility in our premium revenues. Our specialty insurance segment markets and underwrites commercial exposures through wholesale brokers, program administrators and other specialty sources. The reaction of these distribution channels to price competition may result in the movement of business and volatility of premium revenues.

The personal lines businesses are characterized by an auto underwriting cycle of loss cost trends. Driving patterns, inflation in the cost of auto repairs and medical care and increasing litigation of liability claims are some of the more important factors that affect loss cost trends. Inflation in the cost of building materials and labor costs and demand caused by weather-related catastrophic events affect personal lines homeowners loss cost trends. We may be unable to increase premiums at the same pace as coverage costs increase. Accordingly, profit margins generally decline in periods of increasing loss costs.

## **ECONOMIC CONDITIONS**

*Economic conditions may adversely affect our business.*

The current challenging national and global economy, as well as negative economic conditions in the future, may adversely impact our business and results of operations. While the volatility of the economic climate makes it difficult for us to predict the overall impact of economic conditions on our business and results of operations, our business may be impacted in a variety of ways.

Negative economic conditions may cause consumers and businesses to decrease their spending, which may impact the demand for our insurance products. For example, declining automotive sales and weaknesses in the housing market generally impact the purchase of our personal auto and homeowners insurance products by consumers and business insurance products by businesses involved in these industries. High levels of unemployment have a tendency to cause the number of workers' compensation claims to increase, as laid-off and unemployed workers may seek workers' compensation benefits to replace their lost healthcare benefits. Similarly, uninsured and underinsured motorist claims may rise. Vacated homes and business properties pose increased insurance industry risk.

Volatility and weakness in the financial and capital markets may negatively impact the value of our investment portfolio. Economic strains on states and municipalities could result in downgrades or defaults or certain municipal obligations.

We may be adversely affected by business difficulties, bankruptcies and impairments of other parties with whom we do business, such as independent agents, key vendors and suppliers, reinsurers or banks, which increases our credit risk and other counterparty risks. Bankruptcies among our current business insurance customers can negatively affect our retention. Reductions in new business start-ups may negatively affect the number of future potential business insurance customers.

In response to economic conditions, the United States federal government and other governmental and regulatory bodies have taken action and may take additional actions to address such conditions. There can be no assurance as to what impact such actions or future actions will have on the financial markets, economic conditions or our Company.

In addition, government spending and monetary policies or other factors may cause the rate of inflation to increase in the future. Inflation can have a significant negative impact on property and casualty insurers because premium rates are established before the amount of losses and loss expenses are known. When establishing rates, we attempt to anticipate increases from inflation subject to the limitations of modeling economic variables. Premium rates may prove to be inadequate due to low trend assumptions arising from the use of historical data. Even when general inflation is relatively modest, price inflation on the goods and services purchased by insurance companies in settling claims can steadily increase. Reserves may develop adversely and become inadequate. Retentions and deductibles may be exhausted more quickly. Interest rate increases in an inflationary environment could cause the values of our fixed income investments to decline.

*Adverse capital and credit market conditions may negatively affect our ability to meet unexpected liquidity needs or to obtain credit on acceptable terms.*

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

The capital and credit markets have experienced significant volatility and disruption. In some cases, the markets have negatively affected the availability of liquidity and credit capacity. In the event that we need access to additional capital to pay our operating expenses, make payments on our indebtedness, pay for capital expenditures or fund acquisitions, our ability to obtain such capital may be constrained and the cost of any such capital may be significant. Our ability to obtain additional financing will depend on numerous factors, such as market conditions, the general availability of credit, the overall availability of credit to our industry, our credit ratings and credit capacity, as well as lenders' perception of our long- or short-term financial prospects. Our access to funds may also be

constrained if regulatory authorities or rating agencies take negative actions. If certain factors were to occur, our internal sources of liquidity may prove to be insufficient and we may not be able to successfully obtain additional financing on satisfactory terms.

## **DISTRIBUTION SYSTEM**

*Our retail agents, who are part of the independent agency distribution channel, are our sole distribution channel for our personal and business insurance segments. Our exclusive use of this distribution channel may constrain our ability to grow at a comparable pace to our competitors that utilize multiple distribution channels. In addition, consumers may prefer to purchase insurance products through alternative channels, such as through the internet, rather than through agents.*

We market our insurance products in our personal and business insurance segments exclusively through independent, non-exclusive insurance agents and brokers, whereas some of our competitors sell their insurance products through direct marketing techniques, the internet or captive insurance agents who sell products exclusively for one insurance company. Throughout its history, the State Auto Group has supported the independent agency system as our distribution channel. However, we recognize that although the number of distribution locations has expanded, the number of independent agencies in the industry has dramatically shrunk over the past decade due to agency purchases, consolidations, bankruptcies and agent retirements. We also recognize that it will be progressively more difficult to expand the number of independent agencies representing us. If we are unsuccessful in maintaining and increasing the number of agencies in our independent agency distribution system, our sales and results of operations could be adversely affected.

The retail agents that market and sell our products also sell products of our competitors. These agents may recommend our competitors' products over our products or may stop selling our products altogether. Our strategy of not pursuing market share at prices that are not expected to produce an underwriting profit can have the effect of making top line growth more difficult. When price competition is intense, this effect is exaggerated by the fact our independent agent distribution force has products to sell from other carriers that may be more willing to lower prices to grow top line sales. Consequently, we must remain focused on attracting and retaining productive agents to market and sell our products. We compete for productive agents primarily on the basis of our financial position, support services, ease of doing business, compensation and product features. Although we make efforts to ensure we have strong relationships with our retail agents and to persuade them to promote and sell our products, we may not be successful in executing these efforts. If we are unsuccessful in attracting and retaining these agents, our sales and results of operations could be adversely affected.

In addition, consumers are increasingly using the internet and other alternative channels to purchase insurance products. While our website provides a significant amount of information about our insurance products, consumers cannot purchase insurance through our website. Instead, consumers must contact one of our independent agents in order to purchase any of our insurance products or make changes to their existing policies. This primary distribution system may place us at a disadvantage with consumers who prefer to purchase insurance products online or through other alternative distribution channels.

## **REGULATION**

*Our business is heavily regulated, and changes in regulation may reduce our profitability and limit our growth.*

We are subject to extensive regulation in the states in which we conduct business. This regulation is generally designed to protect the interests of policyholders, as opposed to shareholders and other investors, and relates to authorization for lines of business, capital and surplus requirements, investment limitations, underwriting limitations, transactions with affiliates, dividend limitations (see Regulation-Dividends in Item 1), changes in control, premium rates and a variety of other financial and non-financial components of an insurance company's business. The NAIC and state insurance regulators are constantly reexamining existing laws and regulations, generally focusing on modifications to holding company regulations, interpretations of existing laws and the development of new laws.

From time to time, some states in which we conduct business have considered or enacted laws that may alter or increase state authority to regulate insurance companies and insurance holding companies. In other situations, states in which we conduct business have considered or enacted laws that impact the competitive environment and marketplace for property and casualty insurance.

The Risk Management and Own Risk Solvency Assessment Model Act (ORSA) calls for insurers to manage a comprehensive enterprise risk management framework that is embedded within company operations by January 2015. Overall, the ORSA is essentially an internal assessment of the risks associated with an insurer's business and the sufficiency of capital resources to support those risks. Each insurer's ORSA process will be unique, reflecting its business, strategy and approach to enterprise risk management. An ORSA Summary Report, supported by internal risk management materials, will be filed with state regulators. We are in the process of working toward timely compliance with the ORSA guidelines and requirements.

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

Nearly all states require licensed insurers to participate in guaranty funds through assessments covering a portion of insurance claims against impaired or insolvent insurers. An increase in the magnitude of impaired companies could result in an increase in our share of such assessments. Residual market or pooling arrangements exist in many states to provide certain types of insurance coverage to those that are otherwise unable to find private insurers willing to insure them. Licensed insurers voluntarily writing such coverage are required to participate in these residual markets or pooling mechanisms. Such participation exposes us to possible

assessments, some of which could be material to our results of operations. The potential availability of recoupments or premium rate increases, if applicable, may not offset such assessments in the financial statements nor do so in the same fiscal periods.

Many of the states in which we operate have passed or are considering legislation restricting or banning the use of credit scoring in rating and/or risk selection in personal lines of business. Similarly, several states have considered restricting insurers' rights to use loss history information maintained in various databases by insurance support organizations. These tools help us price our products more fairly and enhance our ability to compete for business that we believe will be profitable. Such regulations would limit our ability, as well as the ability of all other insurance carriers operating in any affected jurisdiction, to take advantage of these tools.

Currently the federal government does not directly regulate the insurance business. However, in recent years the state insurance regulatory framework has come under increased federal scrutiny. Congress and some federal agencies from time to time investigate the current condition of insurance regulation in the United States to determine whether to impose federal regulation or to allow an optional federal charter, similar to banks. In addition, changes in federal legislation and administrative policies in several areas, including changes in the Gramm-Leach-Bliley Act, financial services regulation and federal taxation, or repeal of McCarran-Ferguson Act (which largely exempts the insurance industry from the federal antitrust laws), could significantly impact the insurance industry and us. In February 2013, the Department of Housing and Urban Development finalized a federal regulation introducing disparate-impact criteria to the sale of homeowners insurance. Such regulation may have a negative effect on our underwriting and pricing of homeowners insurance, as it puts in jeopardy the use of longstanding, sound actuarial factors. We are monitoring the impact of this recent legislation.

The Federal Insurance Office was established in 2010 by the enactment of the Dodd-Frank Act. The Federal Insurance Office is a separate office within the United States Department of Treasury. The primary objective of the Federal Insurance Office is to monitor all aspects of the insurance industry. The Federal Insurance Office also coordinates and develops federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors, assists in negotiating certain international agreements, monitors access to affordable insurance by traditionally underserved communities and consumers, minorities, and low- and moderate-income persons, and assists in the administration of the terrorism risk insurance program. However, the Federal Insurance Office lacks regulatory authority, and it is not clear how this federal office will coordinate and interact with the NAIC or state insurance regulators.

Although we do not write health insurance, rules affecting health care services can affect other insurance that we write, including workers compensation and commercial and personal automobile and liability insurance. The enactment of the Patient Protection and Affordable Care Act of 2010 (the Healthcare Act) and additional health care reform legislation may have an impact on various aspects of our business. In addition, we may be impacted as a business enterprise by potential tax issues and changes in employee benefits. We will continue to monitor and assess the impact of health care legislation or regulations, or changing interpretations, at the federal or state levels.

We cannot predict with certainty the effect any enacted, proposed or future state or federal legislation or NAIC initiatives may have on the conduct of our business. Furthermore, there can be no assurance that the regulatory requirements applicable to our business will not become more stringent in the future or result in materially higher costs than current requirements. For example, concerns over climate change may prompt federal, state or local laws intended to protect the environment. Changes in the regulation of our business may reduce our profitability, limit our growth or otherwise adversely affect our operations.

We could be adversely affected if our controls designed to assure compliance with guidelines, policies, and legal and regulatory standards are ineffective. Our business is dependent on our ability to regularly engage in a large number of insurance underwriting, claim processing, personnel and human resources, and investment activities, many of which are complex. These activities often are subject to internal guidelines and policies, as well as legal and regulatory requirements. No matter how well designed and executed, control systems provide only reasonable assurance that the system objectives will be met. If our controls are not effective, it could lead to financial loss, unexpected risk exposures or damage to our reputation.

***Tax legislation initiatives or challenges to our tax positions could adversely affect our results of operations and financial condition.***

We are subject to the tax laws and regulations of the United States federal, state and local governments. Tax legislative initiatives by these governmental bodies, including actions by departments of insurance, taxing authorities and other state and local agencies, to change the current tax structure or to increase taxes, assessments and other revenue-generating fees may increase the cost of doing business in those states.

For example, in February 2013, the Governor of Ohio issued a proposed budget for Ohio for the 2014-2015 biennium known as House Bill 59 ( HB 59 ). Among other things, HB 59 proposes to broaden Ohio's sales tax base to provide for the taxation of nearly all services and transfers of intangible property. HB 59 exempts certain services considered to be necessities, which includes consumer insurance transactions. However, insurance, financial and other services that we receive or provide may be subject to sales tax. HB 59 does not provide an exemption for services provided by affiliates. At this time, HB 59 is only proposed and must proceed through an extensive legislative process before it is approved and becomes law, and it may dramatically change as it proceeds through this process.





From time to time, various legislative initiatives may be proposed that could adversely affect our tax positions. There can be no assurance that our effective tax rate or tax payments will not be adversely affected by these initiatives. In addition, United States federal, state and local tax laws and regulations are extremely complex and subject to varying interpretations. There can be no assurance that our tax positions will not be challenged by relevant tax authorities or that we would be successful in any such challenge.

## **CLAIM AND COVERAGE DEVELOPMENTS**

*Developing claim and coverage issues in our industry are uncertain and may adversely affect our insurance operations.*

As industry practices and legislative, judicial and regulatory conditions change, unexpected and unintended issues related to claims and coverage may develop. These issues could have an adverse effect on our business by either extending coverage beyond our underwriting intent or by increasing the frequency or severity of claims. The premiums we charge for our insurance products are based upon certain risk expectations. When legislative, judicial or regulatory authorities expand the burden of risk beyond our expectations, the premiums we previously charged or collected may no longer be sufficient to cover the risk, and we do not have the ability to retroactively modify premium amounts. Furthermore, our reserve estimates do not take into consideration a major retroactive expansion of coverage through legislative or regulatory actions or judicial interpretations.

In particular, court decisions have had, and are expected to continue to have, significant impact on the property and casualty insurance industry. Court decisions may increase the level of risk which insurers are expected to assume in a number of ways, such as by eliminating exclusions, increasing limits of coverage, creating rights in claimants not intended by the insurer and interpreting applicable statutes expansively to create obligations on insurers not originally considered when the statute was passed. In some cases, court decisions have been applied retroactively. Court decisions have also negated legal reforms passed by state legislatures.

We have seen instances of political pressure exerted to force or persuade insurers to provide extra-contractual coverage, such as foregoing the use of deductibles. Such situations may, to some degree, threaten the sanctity of the insurance contract.

There is also a growing trend of plaintiffs targeting property and casualty insurers, including us, in putative class action litigation relating to claim-handling and other practices, particularly with respect to the handling of personal lines auto and homeowners claims.

There are concerns that the focus on climate change and global warming could affect court decisions or result in litigation, including potential matters arising from federal, state or local laws intended to protect the environment.

Many of these issues are beyond our control. The effects of these and other unforeseen claims and coverage issues are extremely hard to predict and could materially harm our business and results of operations.

## **LITIGATION**

*We may suffer losses from litigation, which could materially and adversely affect our operating results or cash flows and financial condition.*

As is typical in our industry, we face risks associated with litigation of various types, including disputes relating to insurance claims under our policies, as well as other general commercial and corporate litigation. Litigation is subject to inherent uncertainties and in the event of an unfavorable outcome in one or more litigation matters, the ultimate liability may be in excess of amounts currently reserved and may be material to our operating results or cash flows for a particular quarter or annual period and to our financial condition.

## **TERRORISM**

*Terrorist attacks, and the threat of terrorist attacks, and ensuing events could have an adverse effect on us.*

Terrorism, both within the United States and abroad, and military and other actions and heightened security measures in response to these types of threats, may cause loss of life, property damage, reduced economic activity, and additional disruptions to commerce. Actual terrorist attacks could cause losses from insurance claims related to the property and casualty insurance operations of the State Auto Group, as well as a decrease in our stockholders' equity, net income and/or revenue.

The Terrorism Acts require the federal government and the insurance industry to share the risk of insured losses on future acts of terrorism that are certified by the U.S. Secretary of the Treasury. In connection with the commercial insurance business we write, we are required to participate. Under the Terrorism Acts, terrorism coverage is mandatory for all primary workers compensation policies. Insureds with non-workers compensation commercial policies, however, have the option to accept or decline our terrorism coverage. In 2012, over 90% of our

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

commercial lines non-workers compensation policyholders purchased terrorism coverage. Under the Terrorism Acts, each participating insurer is responsible for paying a deductible of specified losses before federal assistance is available. This deductible is based on 20% of the prior year's applicable commercial lines premiums. For losses above the deductible, the federal government will pay 85%, up to an industry limit of \$100 billion, and the insurer retains 15%. Although the

Terrorism Acts provisions will mitigate our exposure to a large-scale terrorist attack, our deductible is substantial and losses could have a material adverse effect on our results of operations, financial condition and liquidity.

In December 2007, the United States Congress extended the Terrorism Acts through December 31, 2014, and made some modest changes to the Terrorism Acts. See Regulation in this Item 1 for a discussion of the Terrorism Acts. It is uncertain beyond December 31, 2014 whether the Terrorism Acts will be renewed, revised or terminated.

In addition, some of the assets in our investment portfolio may be adversely affected by declines in the equity markets and economic activity caused by the continued threat of terrorism, ongoing military and other actions and heightened security measures. We cannot predict at this time whether and the extent to which industry sectors in which we maintain investments may suffer losses as a result of potentially decreased commercial and economic activity, or how any such decrease might impact the ability of companies within the affected industry sectors to pay interest or principal on their securities, or how the value of any underlying collateral might be affected.

## INVESTMENTS

*The performance of our investment portfolios is subject to investment risks.*

Like other property and casualty insurance companies, we depend on income from our investment portfolio for a portion of our revenues and earnings and are therefore subject to market risk, credit risk, concentration risk, liquidity risk and the risk that we will incur losses due to adverse changes in equity, interest, commodity or foreign currency exchange rates and prices. Our primary market risk exposures are to changes in interest rates and equity prices. Continuation of the current low interest rate environment puts downward pressure on investment income. Future increases in interest rates could cause the values of our fixed income portfolios to decline, with the magnitude of the decline depending on the duration of our portfolio. Individual securities in our fixed income portfolio are subject to credit risk and default. Downgrades in the credit ratings of fixed maturities can have a significant negative effect on the market valuation of such securities. For example, budget strains on certain states and local governments could negatively affect the credit quality and ratings of their issued securities.

Our fixed income portfolio includes certain securities with call features permitting them to be redeemed by the issuers prior to stated maturity. Reinvestment risk exists with such securities as it may not be possible to reinvest the proceeds from the called securities at equivalent yields.

If the fixed income or equity portfolios, or both, were to be impaired by market, sector or issuer-specific conditions to a substantial degree, our liquidity, financial position and financial results could be materially adversely affected. Under these circumstances, our income from these investments could be materially reduced, and declines in the value of certain securities could further reduce our reported earnings and capital levels. A decrease in value of our investment portfolio could also put our insurance subsidiaries at risk of failing to satisfy regulatory minimum capital requirements. If we were not at that time able to supplement our subsidiaries' capital from STFC or by issuing debt or equity securities on acceptable terms, our business could be materially adversely affected. Also, a decline in market rates of fixed income securities or a decline in the fair value of equity securities could cause the investments in our pension plans to decrease, resulting in additional expense and increasing required contributions to the pension plan.

In addition, our investments are subject to risks inherent in the nation's and world's capital markets. The functioning of those markets, the values of the investments held by us and our ability to liquidate investments on favorable terms or short notice may be adversely affected if those markets are disrupted or otherwise affected by local, national or international events, such as power outages, system failures, wars or terrorist attacks or by recessions or depressions, a significant change in inflation expectations, a significant devaluation of governmental or private sector credit, currencies or financial markets and other factors or events.

Changes in tax laws impacting marginal tax rates and/or the preferred tax treatment of municipal obligations under current law, could adversely affect the market value of municipal obligations. Since a significant portion of our investment portfolio is invested in tax-exempt municipal obligations, any such changes in tax law could adversely affect the value of the investment portfolio. Additionally, any such changes in tax law could reduce the difference between tax-exempt interest rates and taxable rates.

## EMPLOYEES

*Our ability to attract, develop and retain talented employees, managers and executives, and to maintain appropriate staffing levels, is critical to our success.*

Our success depends on our ability to attract, train, develop and retain talented, diverse employees, including executives and other key managers in a specialized industry. Our loss of certain key officers and employees or the failure to attract and develop talented new executives and managers could have a materially adverse effect on our business. Talent management is a key consideration in our specialty insurance segment,

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

which requires specialized product underwriting, claims handling and risk management services and involves distribution through channels other than our retail agents.

In addition, we must forecast the changing business environments (for multiple business units and in many geographic markets) with reasonable accuracy and adjust hiring programs and/or employment levels accordingly. Our failure to recognize the need for such adjustments, or the failure or inability to react appropriately on a timely basis, could lead either to over-staffing (which would

adversely affect our cost structure) or under-staffing (impairing our ability to execute and effectively service our ongoing and new business) in one or more business units or locations. In either event, our financial results could be materially adversely affected.

#### **CREDIT AND FINANCIAL STRENGTH RATINGS**

*A downgrade in our financial strength ratings may negatively affect our business and a downgrade in our credit rating could negatively affect the cost and availability of debt financing.*

Insurance companies are subject to financial strength ratings produced by external rating agencies. Higher ratings generally indicate financial stability and a strong ability to pay claims. Ratings are assigned by rating agencies to insurers based upon factors that they believe are relevant to policyholders and creditors. Ratings are important to maintaining public confidence in our Company and in our ability to market our products. A downgrade in our financial strength ratings could, among other things, negatively affect our ability to sell certain insurance products, our relationships with agents and our ability to compete.

Although other agencies cover the property and casualty industry, we believe our ability to write business is most influenced by our rating from A.M. Best. According to A.M. Best, its ratings are designed to assess an insurer's financial strength and ability to meet ongoing obligations to policyholders. The State Auto Group's current financial strength rating from A.M. Best is A (Excellent) with a stable outlook. The State Auto Group's current financial strength rating from Moody's is A3 with a negative outlook and from Standard & Poor's is BBB+ with a negative outlook.

Generally, credit ratings affect the cost, type and availability of debt financing. Higher rated securities receive more favorable pricing and terms relative to lower rated securities at the time of issue. The State Auto Group's current credit rating from A.M. Best is bbb with a stable outlook. The State Auto Group's current credit ratings from Moody's is Baa3 with a negative outlook and from Standard & Poor's is BB+ with a negative outlook.

Based on future results and developments, we may not be able to maintain our current ratings.

#### **CONTROL BY OUR PARENT COMPANY**

*Our parent company owns a significant interest in us and may exercise its control in a manner detrimental to your interests.*

As of December 31, 2012, our parent company owned approximately 62% of the voting power of our Company. Therefore, State Auto Mutual has the power to direct our affairs and is able to determine the outcome of substantially all matters required to be submitted to shareholders for approval, including the election of all our directors. State Auto Mutual could exercise its control over us in a manner detrimental to the interests of other STFC shareholders.

#### **COMPETITION**

*Our industry is highly competitive, which could adversely affect our sales and profitability.*

The property and casualty insurance business is highly competitive, and we compete with a large number of other insurers. Many of our competitors have well-established national reputations and brands supported by extensive media advertising. Many of our competitors have substantially greater financial, technical and operating resources and market share than we. We may not be able to effectively compete, which could adversely affect our sales or profitability. We believe that competition in our lines of business is based primarily on price, service, commission structure, product features, financial strength ratings, producer relationships, reputation and name or brand recognition. Market developments such as usage-based auto insurance could potentially result in reduced market share or adverse selection. The growth in mobile communications and the prominence of social media as a source of information for consumers are recent examples of significant developments in the marketplace which may adversely affect our competitive position. Social media, for example, could be potentially utilized in a manner which negatively affects our reputation with current or prospective policyholders and agents.

Our competitors sell through various distribution channels, including independent agents, captive agents and directly to the consumer. We compete not only for personal and business insurance customers, but also for independent agents and brokers to market and sell our products. Our specialty insurance segment faces competitors attempting to sell their products through the distribution system of wholesale brokers, program administrators and other specialty sources. Some of our competitors offer a broader array of products, have more competitive pricing or have higher claims paying ability ratings. In addition, other financial institutions are now able to offer services similar to our own as a result of the Gramm-Leach-Bliley Act.

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

The increased transparency that arises from information available from the use of tools such as comparative rater software, could work to our disadvantage. We may have difficulty differentiating our products or becoming among the lowest cost providers. Expense efficiencies are important to maintaining and increasing our growth and profitability. If we are unable to efficiently execute and realize future expense efficiencies, it could affect our ability to establish competitive pricing and could have a negative effect on new business growth and retention of existing policyholders.

## **VOLATILITY OF OUR COMMON STOCK**

*The price of our common stock could be volatile.*

The trading price of our common stock may fluctuate substantially due to a variety of factors, some of which may not be related to our operating performance and are beyond our control. Such factors include, but are not limited to, the following: volatility and variations in our actual or anticipated operating results or changes in the expectations of financial market analysts; investor perceptions of our Company and/or the property and casualty industry; market conditions in the insurance industry and any significant volatility in the market; and major catastrophic events.

## **CHANGES IN ACCOUNTING STANDARDS**

*Changes in accounting standards issued by the FASB or other standard-setting bodies may adversely affect our results of operations and financial condition.*

Our financial statements are prepared in accordance with GAAP. FASB, AICPA and other accounting standard-setting bodies may periodically issue changes to, interpretations of or guidance with respect to GAAP. The adoption of such guidance may have an adverse effect on our results of operations and financial position. See Note 1 to our consolidated financial statements included in Item 8 of this Form 10-K regarding adoption of recent accounting pronouncements, such as our adoption, effective January 1, 2012, of the updated guidance regarding the accounting for costs associated with acquiring or renewing insurance contracts.

## **ACQUISITIONS**

*Acquisitions subject us to a number of financial and operational risks.*

Since going public in 1991, we and State Auto Mutual have acquired or affiliated with other insurance companies, most recently the 2009 acquisition of the Rockhill Insurance Group by State Auto Mutual. It is possible that we and State Auto Mutual will continue to pursue acquisitions or affiliations of other insurance companies in the future.

Insurance company acquisitions and affiliations involving State Auto Mutual generally do not have a material financial impact on State Auto Financial unless and until the target insurers are added to our Pooling Arrangement, such as the addition of the Rockhill Insurers in 2011.

Acquisitions and affiliations involve numerous risks and uncertainties, such as:

obtaining necessary regulatory approvals may prove to be more difficult than anticipated;

integrating the business may prove to be more costly than anticipated;

integrating the business without material disruption to existing operations may prove to be more difficult than anticipated;

anticipated cost savings may not be fully realized (or not realized within the anticipated time frame);

loss results of the acquired or affiliated company or business may be worse than expected;

losses may develop differently than what we expected them to; and

retaining key employees of the acquired company or business may prove to be more difficult than anticipated.



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

In addition, other companies in the insurance industry have similar acquisition and affiliation strategies. Competition for target companies or businesses may intensify or we may not be able to complete such acquisitions or affiliations on terms and conditions acceptable to us. There is no assurance that any businesses acquired in the future will be successfully integrated. Ineffective integration may adversely affect our results and our ability to compete. Also, the acquired business may not perform as projected and anticipated cost savings and other synergies may not be realized.

### **Item 1B. Unresolved Staff Comments**

None.

### **Item 2. Properties**

We share our operating facilities with State Auto Mutual pursuant to the terms of the 2005 Management Agreement. Our corporate headquarters are located in Columbus, Ohio, in buildings owned by State Auto Mutual that contain approximately 280,000 square feet of office space. Our Company and State Auto Mutual also own and lease other office facilities in numerous locations throughout the State Auto Group's geographical areas of operation.

### **Item 3. Legal Proceedings**

We are involved in numerous lawsuits arising in the ordinary course of our business operations arising out of or otherwise related to our insurance policies. Certain of these lawsuits allege extra-contractual damages. These lawsuits are in various stages of

development. We generally contest these matters vigorously but may pursue settlement if appropriate. We consider all such litigation in establishing our loss and loss adjustment expense reserves. Based on currently available information, we do not believe it is reasonably possible that any such lawsuit or related lawsuits will be material to our results of operations or have a material adverse effect on our consolidated financial or cash flow position.

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

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

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

**Item 4. Mine Safety Disclosures**

None.

## PART II

## Item 5. Market for the Registrant's Common Equity, Related Shareholder Matters, and Issuer Purchases of Equity Securities

## Market Information; Holders of Record

Our common shares are traded on the NASDAQ Global Select Market under the symbol STFC. As of February 25, 2013, there were 1,233 shareholders of record of our common shares.

## Market Price Ranges and Dividends Declared on Common Shares

Initial Public Offering June 28, 1991 \$2.25 The following table sets forth information with respect to the high and low sale prices of our common shares for each quarterly period for the past two years as reported by NASDAQ, along with the amount of cash dividends declared by us with respect to our common shares for each quarterly period for the past two years:

2012	High	Low	Dividend
First Quarter	\$ 16.00	\$ 12.21	\$ 0.15
Second Quarter	14.79	12.82	0.15
Third Quarter	16.91	12.49	0.15
Fourth Quarter	16.88	13.93	0.10
2011	High	Low	Dividend
First Quarter	\$ 18.35	\$ 14.90	\$ 0.15
Second Quarter	18.28	15.16	0.15
Third Quarter	18.00	11.83	0.15
Fourth Quarter	14.06	10.09	0.15

(1) Adjusted for stock splits.

On March 1, 2013, the Board of Directors of State Auto Financial declared a cash dividend of \$0.10 per share. The dividend is payable on March 29, 2013, to shareholders of record on March 13, 2013. Additionally, see Item 7 of this Form 10-K, Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Regulatory Considerations, for additional information regarding regulatory restrictions on the payment of dividends to State Auto Financial by its insurance subsidiaries.

**Performance Graph**

The line graph below compares the total return on \$100.00 invested on December 31, 2007, in STFC's shares, the CRSP Total Return Index for the NASDAQ Stock Market ( NASDAQ Index ), and the CRSP Total Return Index for NASDAQ insurance stocks ( NASDAQ Ins. Index ), with dividends reinvested.

	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012
STFC	100.00	116.58	74.32	72.59	59.04	<b>67.39</b>
NASDAQ Index	100.00	60.20	87.51	103.39	102.57	<b>120.67</b>
NASDAQ Ins. Index	100.00	90.43	93.45	110.39	116.63	<b>136.15</b>

**Item 6. Selected Consolidated Financial Data***(dollars and shares in millions, except per share data)*

	2012	Year ended December 31:			
		2011* As Adjusted**	2010* As Adjusted**	2009 As Adjusted**	2008* As Adjusted**
<b>Statement of Income Data</b>					
<b>GAAP Basis:</b>					
Earned premiums	\$ 1,042.1	1,428.8	1,257.2	1,176.5	1,126.0
Net investment income	\$ 75.4	85.4	80.8	82.1	87.4
Total revenues	\$ 1,150.1	1,553.7	1,355.1	1,256.9	1,181.9
Net income (loss)	\$ 10.7	(160.7)	24.4	9.3	(32.9)
Earned premium growth	(27.1)%	13.6	6.9	4.5	11.3
Return on average invested assets <sup>(1)</sup>	3.5%	3.6	3.6	3.9	4.1
<b>Balance Sheet Data</b>					
<b>GAAP Basis:</b>					
Total investments	\$ 2,268.4	2,229.9	2,307.1	2,179.1	1,941.3
Total assets	\$ 2,477.8	2,764.4	2,701.4	2,544.0	2,422.7
Total notes payable	\$ 115.9	116.4	116.8	117.2	117.6
Total stockholders' equity	\$ 737.2	723.8	831.2	828.9	740.1
Common shares outstanding	40.5	40.3	40.1	39.8	39.5
Return on average equity	1.5	(20.7)	2.9	1.2	(4.0)
Debt to capital ratio	13.6	13.9	12.3	12.4	13.7
<b>Per Common Share Data</b>					
<b>GAAP Basis:</b>					
Basic EPS	\$ 0.26	(4.00)	0.61	0.23	(0.83)
Diluted EPS	\$ 0.27	(4.00)	0.61	0.23	(0.83)
Cash dividends per share	\$ 0.55	0.60	0.60	0.60	0.60
Book value per share	\$ 18.22	17.95	20.71	20.81	18.70
<b>Common Share Price:</b>					
High	\$ 16.91	18.35	20.38	30.25	37.08
Low	\$ 12.21	10.09	13.40	14.29	17.38
Close at December 31	\$ 14.94	13.59	17.42	18.50	30.06
Close price to book value per share	0.82	0.76	0.84	0.89	1.61
<b>GAAP Ratios:</b>					
Loss and LAE ratio	74.7%	82.6	70.8	71.7	75.2
Expense ratio	33.2%	33.9	33.8	34.2	34.9
Combined ratio	107.9%	116.5	104.6	105.9	110.1
<b>Statutory Ratios:</b>					
Loss and LAE ratio	74.8%	82.4	70.3	71.3	74.8
Expense ratio	33.6%	33.9	32.9	33.5	33.1
Combined ratio	108.4%	116.3	103.2	104.8	107.9
Net premiums written to surplus	1.7	2.1	1.7	1.5	1.6

<sup>(1)</sup> Invested assets include investments and cash equivalents.

\* Reflects changes in Pooling Arrangement, effective December 31, 2011, January 1, 2011, 2010 and 2008.

\*\* As previously reported, we adopted with retrospective application at January 1, 2012 Accounting Standards Update 2010-26, Accounting for Costs Associated with Acquiring and Renewing Insurance Contracts. All applicable prior period amounts have been adjusted to conform to current period presentation. See Critical Accounting Policies-Deferred Acquisition Costs included in Item 7 of this Form 10-K.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Capitalized terms used in this Item 7 and not otherwise defined have the meanings ascribed to such terms under the caption "Important Defined Terms Used in this Form 10-K" which immediately precedes Part I of this Form 10-K. This discussion should be read in conjunction with the consolidated financial statements and notes thereto included in Item 8 of this Form 10-K and the narrative description of our business contained in Item 1 of this Form 10-K.

### OVERVIEW

State Auto Financial is a property and casualty insurance holding company. Our insurance subsidiaries are part of the State Auto Group and Pooling Arrangement described below. The State Auto Group markets its insurance products throughout the United States primarily through independent agencies, which include retail agencies and brokers. Our Pooled Companies are rated A (Excellent) by A.M. Best.

State Auto Financial's principal subsidiaries are State Auto P&C, Milbank and SA Ohio, each of which is a property and casualty insurance company, and Stateco, which provides investment management services to affiliated insurance companies.

Since January 1, 2011, our reportable insurance segments have been personal insurance, business insurance and specialty insurance. These insurance segments are aligned with the reporting lines to our principal operating decision makers. Investment operations is also a reportable segment. As of January 1, 2013, our units within the specialty insurance segment will change from RED, Rockhill and Workers' Compensation to Property, Casualty, Workers' Compensation and Programs. See "Personal and Business Insurance" and "Specialty Insurance" in Item 1 of this Form 10-K for more information about our insurance segments.

We evaluate the performance of our insurance segments using industry financial measurements determined under SAP and certain measures determined under GAAP. We evaluate our investment operations segment based on investment returns of assets managed. Financial information about our segments for 2012 is set forth in this Item 7 and in Note 14 to our consolidated financial statements included in Item 8 of this Form 10-K. Prior period segment information has been restated to conform to current period presentation.

### EXECUTIVE SUMMARY

To deliver operating and financial results, we focus on our insurance segments—personal insurance, business insurance and specialty insurance, along with our investment operations segment. Underlying these segments are performance disciplines that we believe are critical to our success: underwriting profitability, risk management and capital management.

#### *Underwriting Profitability*

While our goal is to consistently produce an underwriting profit, our combined ratio has exceeded 100% for the last five years. This result has largely been due to catastrophe and other weather-related losses in our property lines of business. Significant efforts are being directed toward returning to prior levels of underwriting profitability.

It is critical that we return our homeowners book of business to underwriting profitability, as it is our second largest line of business after personal auto. A multi-year effort to implement solutions includes an aggressive insurance to value program that audits policy coverage against the actual value of the property. We have also implemented separate, mandatory wind and hail deductibles for properties in select catastrophe prone states and by-peril rating for homeowners in the majority of our states. By-peril rating calculates a separate premium component for each peril and allows us to price more effectively for weather risks, which is the leading cause of homeowners' losses. Our claim handling has become more specialized with the addition of dedicated large and small property claim handlers and the formation of a catastrophe claim team, lessening our dependency on independent adjusters. We're also continuing our efforts to diversify geographically. Finally, we continue to aggressively address our rate needs in homeowners, where we expect to achieve rate adequacy during 2013.

Pricing the property and casualty insurance product has become a sophisticated science. To that end, we have made significant investment in our actuarial and financial teams, adding depth and talent to these important functions. We have also enhanced our product management discipline, which uses objective analysis of company results, competitor results and marketplace dynamics to develop, monitor and communicate state strategies. Through product management, we are attempting to capitalize on pricing segmentation, risk selection, portfolio mix and competitive position to optimize profit and growth. We are dedicated to cost-based pricing, with each line of business priced to generate a profit.

We believe changes in our claim organization have positively impacted claims efficiency, improved service and reduced costs. We have reduced salvage yard vendor fees through negotiation with vendors. A new auto physical damage unit has significantly reduced independent adjuster expenses and improved claims file administration on auto physical damage claims, while expansion of our house counsel operation not only contributes to lower claim expenses, but improves service. We believe that our claim performance has been enhanced by our restructuring and

business process improvement efforts, and the claim organization will continue to be a significant contributor to improving our ex-catastrophe loss and expense ratio performance.

### ***Risk Management***

The focus of our enterprise risk management practices are to identify, assess, manage and monitor the frequency and severity of all potential risks. Numerous risks have been identified and are being managed, including a variety of underwriting, operational, market, credit and strategic risks. All of our business units play important roles in risk identification and in the development and execution of risk management strategies.

Catastrophes have been the onerous variable in our profitability formula in recent years. We are committed to geographic diversity, which means reducing our property risk concentrations in certain geographic regions while at the same time expanding into new states with new relationships. We believe geographic diversity is a classic but effective way to spread risk and reduce volatility.

We strengthened our risk management capability in 2012 through the appointment of a new chief risk officer who reports directly to our CEO. Through this position, we will sharpen our ability to operationalize and integrate risk management capabilities into our capital management, product development, pricing, claims and service capabilities.

### ***Capital Management***

Our number one goal remains to earn an appropriate risk adjusted return for our shareholders while growing book value. Unprecedented catastrophe losses in 2011, for both us and the insurance industry, impacted our underwriting results and capital levels. In response, we implemented several actions at the end of 2011 to strengthen capital, improve our risk profile and begin restoring book value.

In addition to the HO QS Arrangement discussed elsewhere, members of the State Auto Group pay a portion of the premiums received to reinsurers in exchange for reinsuring a portion of our exposures. Reinsurance reduces our net liability on individual risks or for individual loss occurrences, including catastrophic losses. We maintain reserves for the eventual payment of losses and loss expenses for both reported claims and incurred claims that have not yet been reported, based on management's best estimate at a given point in time. Although management uses many resources to calculate reserves, there is not a precise method for determining the ultimate liability. Our objective is to set reserves that will reasonably approximate the ultimate liability for insured losses and loss expenses. We regularly review and adjust loss reserves as appropriate.

Our investment operations segment maintains a disciplined investment strategy by owning a well-diversified portfolio of investment grade fixed income securities and equity securities. We manage all of our fixed income securities internally. We manage our U.S. large-cap equity portfolio internally and utilize outside managers for our U.S. small-cap equities and international equity funds. We believe that over the long term this diversified portfolio will provide us with the best income and growth possibilities while protecting principal and providing adequate liquidity to support our business operations.

### **CRITICAL ACCOUNTING POLICIES**

Our significant accounting policies are more fully described in Note 1 of the notes to our consolidated financial statements included in Item 8 of this Form 10-K. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, revenues and expenses for the period then ended and the financial entries in the accompanying notes to the financial statements. Such estimates and assumptions could change in the future, as more information becomes known which could impact the amounts reported and disclosed in this Item 7. We have identified the policies and estimates described below as critical to our business operations and the understanding of the results of our operations.

### ***Investments***

Our fixed maturity, equity security and certain other invested asset investments are classified as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are shown as a separate component of stockholders' equity in accumulated other comprehensive income (loss), and as such are not included in the determination of net income. Investment income is recognized when earned, and capital gains and losses are recognized when investments are sold.

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



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

not reversed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in other comprehensive income (loss).

We also consider the following factors when assessing our fixed maturity investments for OTTI: (1) the financial condition of the issuer including receipt of scheduled principal and interest cash flows; (2) our intent to sell; and (3) if it is more likely than not that we will be required to sell the investments before recovery. When a fixed maturity has been determined to have 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 other comprehensive income (loss). Future increases or decreases in fair value, if not other-than-temporary, are included in other comprehensive income (loss).

#### ***Deferred Acquisition Costs***

As of January 1, 2012, we adopted retrospectively the FASB guidance *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. See *New Accounting Standards Adoption of Accounting Pronouncements Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* included in this Item 7 and in Note 1 of our consolidated financial statements included in Item 8 of this Form 10-K for the impact of this adoption at January 1, 2010. The cumulative effect of this retrospective adoption of this guidance reduced stockholders' equity by \$20.5 million, after-tax, at January 1, 2010. All applicable prior period amounts have been adjusted to conform to current period presentation. Acquisition costs, consisting of commissions, premium taxes and certain underwriting expenses related to the successful acquisition of acquiring or renewing the production of property and casualty business, are deferred and amortized over the same period in which the related premiums are earned. The method followed for computing the acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premiums to be earned, losses and loss expenses expected to be incurred, and certain other costs expected to be incurred as premium is earned. Future changes in estimates, the most significant of which is expected losses and loss adjustment expenses, that indicate a reduction in expected future profitability may result in unrecoverable deferred acquisition costs.

#### ***Losses and Loss Expenses Payable***

Our loss reserves reflect all unpaid amounts for claims that have been reported, as well as for IBNR claims. Our loss reserves are not discounted to present value.

Loss reserves are management's best estimates (MBE) at a given point in time of what we expect to pay to settle all claims incurred as of that date based on known facts, circumstances and historical trends. Loss reserves at the individual claim level are established on either a case reserve basis or formula reserve basis depending on the type and circumstances of the loss. The case reserve amounts are determined by claims adjusters based on our reserving practices, which take into account the type of risk, the circumstances surrounding each claim and applicable policy provisions. The formula reserves are based on historical data for similar claims with provision for changes caused by inflation. Case reserves and formula reserves are reviewed on a regular basis, and as new data becomes available, estimates are updated resulting in adjustments to loss reserves. Generally, reported losses initially reserved on a formula basis and not settled after six months are case reserved at that time. The process for calculating the IBNR component of the loss reserve is to develop an estimate of the ultimate losses and allocated loss expenses incurred, and subtract all amounts already paid or held as case or formula reserves.

The determination of ultimate losses integrates information and analysis provided by several disciplines within our Company, including claims, actuarial and accounting. This assessment requires considerable judgment in understanding how claims mature, which lines of business are the most volatile, and how trends change over time. Loss reserves represent an estimate at a given point in time based on many variables including historical and statistical information, inflation, legal developments, storm loss estimates and economic conditions. Although we consider many different sources of information, as well as a number of actuarial methodologies to estimate our loss reserves, there is no single method for determining the exact ultimate liability.

Our internal actuarial staff conducts quarterly reviews of projected loss development information to assist management in making estimates of ultimate losses and loss expenses. Several factors are considered in estimating ultimate liabilities including consistency in relative case reserve adequacy, consistency in claims settlement practices, recent legal developments, historical data, actuarial projections, accounting projections, exposure growth, current business conditions, catastrophe developments and late reported claims. In addition, reasonableness tests are performed on many of the assumptions underlying each reserving methodology, such as claim frequency, claim severity and loss ratios. Nonetheless, changes which are not contemplated do occur over time, and those changes are incorporated in subsequent valuations of our loss reserves.

We use a number of different methodologies to estimate the IBNR component of our loss reserves. Our loss reserves include amounts related to short tail and long tail lines of business. Tail refers to the time period between the occurrence of a loss and the settlement of the claim. In general, the longer the time span between the incidence of a loss and the settlement of the claim, the more the ultimate settlement amount can vary. The reserving methods and strengths and weaknesses of each are described below.

***Short-Tail Business:*** For short-tail business, claims are typically settled within five years, and the most common actuarial estimates are based on techniques using link ratio projections of incurred losses, paid losses, claim counts and claim severities. Each of these methods is described below in detail. Separate projections are made for catastrophes that are in the very early stages of development based on specific information

known through the reporting date.

***Incurred Loss Development Method:*** The Incurred Loss Development Method is probably the most common actuarial method used in projecting indicated IBNR reserves. This method uses paid loss experience as well as the outstanding estimates (formula and

case reserves) for claims that have been reported and are still open. The underlying assumption of the Incurred Loss Development Method is that case reserve adequacy remains consistent over time. This method's advantage is its responsiveness to changes in reported losses, which is particularly valuable in the less mature accident years. The disadvantage of the Incurred Loss Development Method is that case reserve adequacy changes will distort the IBNR projections.

***Paid Loss Development Method:*** The Paid Loss Development Method uses calculations that are very similar to the Incurred Loss Development Method. The key difference is that the data used in the paid method exclude case reserve estimates, so only paid losses are utilized. With this method, a payment pattern is estimated to project ultimate settlement values for each accident year, with the underlying assumption that claims are settled at a consistent rate over time. Neither case reserves nor the rate at which claims are reported (except to the extent that the reporting pattern influences the payment pattern) is relevant to the results of this method. This method's advantage is the estimates of ultimate loss are independent of case reserve adequacy and are unaffected by company changes in case reserving philosophy. The disadvantages are that the paid method does not use all of the available information, and in some cases the liability payment patterns require the application of very large development factors to relatively small payments in less mature accident years.

***Claim Counts and Severities Method:*** The Counts and Severities Method calculations are very similar to the other methods. The incurred claim counts reported to date are projected to an ultimate number. Similarly, the incurred loss severities are projected to an ultimate value. The ultimate incurred count is multiplied by the ultimate incurred severity, for each accident year, to arrive at the ultimate incurred loss. Finally, as with the other loss development methods, an estimate of the IBNR reserve is calculated by subtracting the reported losses from the estimated ultimate losses.

***Long-Tail Business:*** For long-tail business, a material portion of claims may not be settled within five years. Reserve estimates for long-tail business use the same methods listed above along with several other methods as determined by the actuary. For example, premium-based methods may be used in developing ultimate loss estimates, including the Expected Loss Ratio, Bornhuetter-Ferguson, and Least-Squares techniques as described below. We may also use statistical models when the historical patterns can be reasonably approximated.

***Expected Loss Ratio Method:*** The Expected Loss Ratio Method generates indicated IBNR by multiplying an expected loss ratio by earned premiums, then subtracting incurred-to-date losses. For slower reporting lines of business, new products, or data that is very immature, the actual claim data is often too limited or too volatile for other projection methods. With this method the premiums are used as a measure of loss exposure, and the loss ratios can be derived from pricing expectations.

***Bornhuetter-Ferguson Method:*** The Bornhuetter-Ferguson Method is a weighted average of the Expected Loss Ratio Method and the Incurred Loss Development Method, using the percentage of losses reported as the weight. This method is particularly useful where there is a low volume of data in the current accident period, or where the experience is volatile. In general, this method produces estimates that are similar to the Incurred Loss Development Method.

***Least Square Loss Development Method:*** In the Least Squares Loss Development Method, the statistical technique of least squares regression is applied to a triangle of reported loss ratios to project the ultimate loss ratio in each accident year. Using historical loss ratios puts the data for each time period on a more consistent exposure basis, because premium levels are generally correlated with insured exposures. A by-product of the regression function is an estimate of credibility for each stage of development. In cases where the regression parameters fall outside of a reasonable range, the projection defaults to the incurred loss method.

***Selection Process:*** In determining which reserving method to use for a particular line of business or accident year, diagnostic tests of loss ratios and severity trends are considered, as well as the historic case reserve adequacy and claim settlement rate. In general, the Incurred Loss Development Method is used if the projections are stable, the data is credible, historic case reserve adequacy is consistent, and the loss ratios and loss severities are reasonable. Other reserving methods are considered as well for particular lines of business or accident years, along with supplemental information such as open claim counts and prior period development. For example, if more than one method provides a reasonable projection, the actuary may select an average of those methods. There is considerable judgment applied in the analysis of the historical patterns and in applying business knowledge of our underwriting and claims functions.

Reserve ranges provide a quantification of the variability in the loss reserve projections. The primary determinant in estimating the loss reserve range boundaries are the variances measured within the historical reserving data for the various lines of business. MBE of loss reserves considers the expected variation to establish an appropriate position within a range. MBE loss and ALAE reserves for the STFC Pooled Companies' share of the Pooled Companies' reserves at December 31, 2012, was \$932.2 million, within an estimated range of \$817.9 million to \$968.6 million. (These values presented are on a direct basis, gross of salvage and subrogation recoverable, and before reinsurance, except for the STFC Pooled Companies' participation in the inter-company Pooling Arrangement. Therefore, these values cannot be compared to other loss and loss expenses payable tables included elsewhere within this Form 10-K.)

The potential impact of the loss reserve variability on net income can be illustrated using the range end points and carried reserve amounts listed above. For example, if ultimate losses reach a level corresponding to the high point of the range, \$968.6 million, the reserve increase of \$36.4

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

million corresponds to an after-tax decrease of \$23.7 million in net income, assuming a tax rate of 35%. Likewise, should ultimate losses decline to a level corresponding to the low point of the range, \$817.9 million, the \$114.3 million reserve decrease would add \$74.3 million of after-tax net income. The loss reserve range noted above represents a range of

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

reasonably likely reserves, not a range of all possible reserves. Therefore, the ultimate losses could reach levels corresponding to reserve amounts outside the range provided.

An important assumption underlying the loss reserve estimation methods for the major casualty lines is that the loss cost trends implicitly built into the loss and ALAE patterns will continue into the future. To estimate the sensitivity of reserves to an unexpected change in inflation, projected calendar year payment patterns were applied to the December 31, 2012, other & product liability loss and ALAE reserve to generate estimated annual incremental loss and ALAE payments for each subsequent calendar year. Then, for purposes of sensitivity testing, an additional annual loss cost trend of 10% was added to the trend implicitly embedded in the estimated payment pattern, and revised incremental loss and ALAE payments were calculated. This type of inflationary increase could arise from a variety of sources including tort law changes, development of new medical procedures, social inflation, and other inflationary changes in costs beyond assumed levels.

The estimated cumulative impact that this additional, unexpected 10% increase in the loss cost trend would have on our results of operations over the lifetime of the underlying claims in other & product liability is an increase of \$100.8 million on reserves, or a \$65.5 million reduction to net income, assuming a tax rate of 35%. Inflation changes have much more impact on the longer tail commercial lines like other & product liability and workers compensation, and much less impact on the shorter tail personal lines reserves.

In addition to establishing loss reserves, as described above, we establish reserves for ULAE. Historical patterns of paid ULAE relative to paid loss are analyzed along with historical claim counts including claims opened, claims closed, and claims remaining open. The product of this analysis is an estimate of the relationship, or ratio, between ULAE and loss underlying the current loss reserves. This ratio is applied to the current outstanding loss reserves to estimate the required ULAE reserve. Consequently, this component of the loss expense reserve has a proportional relationship to the overall claim inventory and held loss reserves. The method assumes that the underlying claims process and mix of business do not change materially over time.

The following table sets forth a reconciliation of MBE of our direct loss and ALAE reserve to our net loss and loss expenses payable at December 31, 2012 and 2011. The STFC Pooled Companies net additional share of transactions assumed from State Auto Mutual through the Pooling Arrangement for the years ended December 31, 2012 and 2011, respectively, has been reflected in the table below as assumed by STFC Pooled Companies.

<i>(\$ millions)</i>	<b>2012</b>	2011
<b><u>Direct loss and ALAE reserve:</u></b>		
STFC Pooled Companies	<b>\$ 494.7</b>	510.0
Assumed by STFC Pooled Companies	<b>437.5</b>	421.1
<i>Total direct loss and ALAE reserve</i>	<b>932.2</b>	931.1
<b><u>Direct ULAE reserve:</u></b>		
STFC Pooled Companies	<b>28.3</b>	28.6
Assumed by STFC Pooled Companies	<b>18.8</b>	17.1
<i>Total direct ULAE reserve</i>	<b>47.1</b>	45.7
<b><u>Direct salvage and subrogation recoverable:</u></b>		
STFC Pooled Companies	<b>(23.6)</b>	(20.9)
Assumed by STFC Pooled Companies	<b>(2.1)</b>	(4.6)
<i>Total direct salvage and subrogation recoverable</i>	<b>(25.7)</b>	(25.5)
Reinsurance recoverable	<b>(13.5)</b>	(25.5)
Assumed reinsurance	<b>7.7</b>	12.6
Reinsurance assumed by STFC Pooled Companies	<b>(19.1)</b>	(56.8)
<i>Total losses and loss expenses payable, net of reinsurance recoverable on losses and loss expenses payable of \$13.5 and \$25.5 in 2012 and 2011, respectively</i>	<b>\$ 928.7</b>	881.6



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

The following tables set forth the loss and loss expenses payable by major line of business at December 31, 2012 and 2011:

(\$ millions)	Ending	Ending	Ending	Total Reserves
	Loss & ALAE	Loss & ALAE	ULAE	
	Case & Formula	IBNR	Bulk	
<b>December 31, 2012</b>				
<u>Personal insurance segment:</u>				
Personal auto	\$ 126.4	49.9	9.8	186.1
Homeowners	22.1	10.3	2.2	34.6
Other personal	7.8	2.3	0.2	10.3
<i>Total personal</i>	<b>156.3</b>	<b>62.5</b>	<b>12.2</b>	<b>231.0</b>
<u>Business insurance segment:</u>				
Commercial auto	38.2	35.5	3.7	77.4
Commercial multi-peril	38.6	37.2	4.6	80.4
Fire & allied lines	18.6	2.3	0.6	21.5
Other & product liability	53.1	91.4	15.1	159.6
Other commercial	2.0	0.8	0.1	2.9
<i>Total business</i>	<b>150.5</b>	<b>167.2</b>	<b>24.1</b>	<b>341.8</b>
<u>Specialty insurance segment:</u>				
<i>Total specialty</i>	<b>150.4</b>	<b>194.2</b>	<b>11.3</b>	<b>355.9</b>
<i>Total losses and loss expenses payable net of reinsurance recoverable on losses and loss expenses payable</i>	<b>\$ 457.2</b>	<b>423.9</b>	<b>47.6</b>	<b>928.7</b>

(\$ millions)	Ending	Ending	Ending	Total Reserves
	Loss & ALAE	Loss & ALAE	ULAE	
	Case & Formula	IBNR	Bulk	
<b>December 31, 2011</b>				
<u>Personal insurance segment:</u>				
Personal auto	\$ 133.9	52.3	9.7	195.9
Homeowners	47.1	22.2	2.6	71.9
Other personal	7.9	3.0	0.3	11.2
<i>Total personal</i>	<b>188.9</b>	<b>77.5</b>	<b>12.6</b>	<b>279.0</b>
<u>Business insurance segment:</u>				
Commercial auto	38.5	34.8	3.6	76.9
Commercial multi-peril	32.6	36.7	4.2	73.5



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

Fire & allied lines	21.4	2.2	0.7	24.3
Other & product liability	58.5	85.3	14.8	158.6
Other commercial	2.5	1.0	0.1	3.6
<i>Total business</i>	153.5	160.0	23.4	336.9
<u>Specialty insurance segment:</u>				
<i>Total specialty</i>	104.4	151.6	9.7	265.7
<i>Total losses and loss expenses payable net of reinsurance recoverable on losses and loss expenses payable</i>	\$ 446.8	389.1	45.7	881.6

See discussion in Results of Operations Loss and LAE section included in this Item 7.

The property and casualty industry has experienced significant loss from claims related to asbestos, environmental remediation, product liability, mold and other mass torts. Because we have insured primarily product retailers and distributors, we do not expect to incur the same level of liability, particularly related to asbestos, as companies that have insured manufacturing risks.

Asbestos reserves are \$1.4 million, and environmental reserves are \$7.0 million, for a total of \$8.4 million, or 0.9% of net losses and loss expenses payable. Asbestos reserves increased \$0.2 million and environmental reserves decreased \$0.8 million from 2011.

**Pension and Postretirement Benefit Obligations**

Pension and postretirement benefit obligations are long-term in nature and require management’s judgment in estimating the factors used to determine these amounts. We review these factors annually, including the discount rate and expected long-term rate of return on plan assets. Because these obligations are based on estimates which could change, the ultimate benefit obligation could be different from the amount estimated.

The State Auto Group has a defined benefit pension plan covering substantially all employees hired prior to January 1, 2010 and a postretirement healthcare plan covering certain associates and retirees (collectively the benefit plans). Several factors, which attempt to anticipate future events, are used in calculating the expense and liability related to the benefit plans. Key factors include assumptions about the expected rates of return on plan assets, discount rates, and health care cost trend rates. We consider market conditions, including changes in investment returns and interest rates, in making these assumptions. The actuarial assumptions used by us in determining benefit obligations may differ materially from actual results due to changing market and economic conditions, higher or lower turnover and retirement rates, or longer or shorter life spans of participants. While we believe that the assumptions used are appropriate, differences in actual experience or changes in assumptions may materially affect our financial position or results of operations.

To calculate the State Auto Group’s December 31, 2012 benefit obligation for each of the benefit plans, we used a discount rate of 4.05% based on an evaluation of the expected future benefit cash flows of our benefit plans used in conjunction with the Citigroup Pension Discount Curve at the measurement date. A lower discount rate results in, all else being equal, a higher present value of the benefit obligation. To calculate our benefit obligation at December 31, 2012 and net periodic benefit cost for the year ended December 31, 2013, a discount rate of 4.05% and an expected long-term rate of return on plan assets of 7.50% were used. We selected an expected long-term rate of return on our plan assets by considering the mix of investments and stability of investment portfolio along with actual investment experience during the lifetime of the plans. Our assumptions regarding the discount rate and expected return on plan assets could have a significant effect on the amounts related to our benefit obligations and net periodic benefit cost depending on the degree of change between reporting periods.

The following table sets forth an illustration of variability with respect to the discount rate on our share of the State Auto Group’s December 31, 2012 benefit obligation and expected net periodic benefit cost for the year ending December 31, 2013, along with the variability of the expected return on plan assets to our expected net periodic benefit cost for the year ending December 31, 2013. Holding all other assumptions constant, sensitivity to changes in any one of our key assumptions are as follows:

(\$ millions)	Pension Discount rate			Postretirement Discount rate		
	-0.25%	4.05%	+0.25%	-0.25%	4.05%	+0.25%
Benefit obligation	\$ 255.9	246.1	237.0	\$ 25.6	25.1	24.6
Net periodic benefit cost (benefit)	\$ 12.3	11.6	10.8	\$ (3.7)	(3.7)	(3.7)
	Expected return on plan assets			Expected return on plan assets		
	-0.25%	7.50%	+0.25%	-0.25%	7.50%	+0.25%
Net periodic benefit cost (benefit)	\$ 12.0	11.6	11.2	\$ (3.7)	(3.7)	(3.7)

The accumulated benefit obligation ( ABO ) of a defined benefit pension plan represents the actuarial present value of benefits attributed by the pension benefit formula to employee service rendered prior to the measurement date and based on current and past compensation levels, while the projected benefit obligation ( PBO ) is the ABO plus a factor for future compensation levels. The ABO, which considers current compensation levels only, provides information about the obligation an employer would have if the plan were discontinued at the measurement date. At December 31, 2012, our share of the State Auto Group’s ABO and PBO was \$223.0 million and \$246.1 million, respectively. At December 31, 2012, STFC’s share of the defined benefit pension plan’s fair value of the assets was \$162.2 million, which resulted in an underfunded status within our balance sheet of \$83.9 million. On a cash flow basis, we target an annual contribution level that meets at least the targeted normal cost plus any shortfall amortizations of the plan, as defined by ERISA. Currently, we expect to make a cash contribution to the pension plan up to \$13.0 million in 2013.

The unfunded status on the pension plan and supplemental executive retirement plan increased from \$87.5 million at December 31, 2011, to \$89.7 million at December 31, 2012. Primarily influencing this increase are actuarial gains and losses arising from factors that include a decrease in the discount rate and expected to actual demographic changes, such as retirement age, mortality, turnover, and rate of compensation changes.



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

See Note 9, Pension and Postretirement Benefit Plans, to our consolidated financial statements included in Item 8 of this Form 10-K for further disclosures regarding our benefit plans.

### *Deferred 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 FASB's ASC Income Taxes Topic (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 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.

During 2011, we experienced a net loss driven by the magnitude of record level catastrophe storm losses in the second quarter which significantly exceeded our projections. We considered both positive and negative evidence and concluded a valuation allowance should be established. At December 31, 2012 and 2011, we recorded a valuation allowance of \$100.5 million and \$103.3 million, respectively. The deferred income tax asset remaining after recognition of the valuation allowance represents a deferred tax asset on the gross unrealized fixed maturity losses where we have concluded this portion of the asset to be realizable due to our assertion that we have both the ability and intent to hold these securities through recovery or maturity.

The following table sets forth the components of our federal income tax expense for the years ended December 31, 2012 and 2011:

<i>(\$ millions)</i>	<b>2012</b>	2011 As Adjusted
Income (loss) before federal income taxes	<b>\$ 10.6</b>	\$ (112.1)
Current tax benefit	<b>(0.1)</b>	(6.4)
Deferred tax benefit	<b>(4.8)</b>	(48.3)
Federal income tax benefit prior to valuation allowance	<b>(4.9)</b>	(54.7)
Valuation allowance	<b>4.8</b>	103.3
Total federal income tax (benefit) expense	<b>(0.1)</b>	48.6
Net income (loss)	<b>\$ 10.7</b>	\$ (160.7)

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

Based on ASC 740 intraperiod tax allocation guidelines, the following sets forth the change in valuation allowance attributable to continuing operations and other comprehensive income for the years ended December 31, 2012 and 2011:

<i>(\$ millions)</i>	For the year ended December 31 <b>2012</b>	For the year ended December 31 2011

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

Continuing operations	\$	4.8	\$	103.3
Other comprehensive income		(7.6)		
Change in valuation allowance	\$	(2.8)	\$	103.3

See Note 8, Federal Income Taxes, to our consolidated financial statements included in Item 8 of this Form 10-K for further disclosures regarding our income tax matters.

**Other**

Other items that could have a significant impact on the financial statements include the risks and uncertainties listed in Item 1A of this Form 10-K under Risk Factors. Actual results could differ materially using different estimates and assumptions, or if conditions are significantly different in the future.

**POOLING ARRANGEMENT**

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

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

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

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

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

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

In 2010, we made the following changes to the Pooling Arrangement (the 2010 pool changes):

Added SA National to the pool with a participation percentage of 0.0%; and

Included voluntary assumed reinsurance from third parties unaffiliated with the Pooled Companies that was assumed on or after January 1, 2009 by State Auto Mutual.

State Auto Financial sold its nonstandard automobile insurance subsidiary, SA National, to a third party on December 31, 2010. Concurrent 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 agreement 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 continued to service policies that were written by us through June 30, 2011. The business assumed by us is subject to the Pooling Arrangement.

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

	January 1, 2010 December 31, 2010	January 1, 2011 December 31, 2011	Close of business December 31, 2011	December 31, 2012
<b>STFC Pooled Companies:</b>				
State Auto P&C <sup>(1)</sup>	62.0%	62.0%	51.0%	51.0%
Milbank	17.0	17.0	14.0	14.0
SA Ohio	1.0	1.0	0.0	0.0
SA National	0.0	N/A	N/A	N/A
<i>Total STFC Pooled Companies</i>	80.0	80.0	65.0	65.0
<b>State Auto Mutual Pooled Companies:</b>				
State Auto Mutual	19.0	19.0	34.0	34.0
SA Wisconsin	0.0	0.0	0.0	0.0
Meridian Security <sup>(2)</sup>	0.0	0.0	0.0	0.0
Meridian Citizens Mutual	0.5	0.5	0.5	0.5
Patrons Mutual	0.4	0.4	0.4	0.4
Litchfield	0.1	0.1	0.1	0.1
RIC	N/A	0.0	0.0	0.0
Plaza	N/A	0.0	0.0	0.0
American Compensation	N/A	0.0	0.0	0.0
Bloomington Compensation	N/A	0.0	0.0	0.0
<i>Total State Auto Mutual Pooled Companies</i>	20.0	20.0	35.0	35.0

<sup>(1)</sup> Includes the pooling participation percentage of Farmers which was merged into State Auto P&C as of the close of business on December 31, 2012. Farmers pooling participation percentage was 3.0% from January 1, 2010 to December 31, 2011.

<sup>(2)</sup> Includes the pooling participation percentages of SA Florida and Beacon National, each of which was merged into Meridian Security as of the close of business on December 31, 2012. Each of SA Florida's and Beacon National's pooling participation percentage was 0.0% from January 1, 2010 to December 31, 2011.

We anticipate that the STFC Pooled Companies will maintain a 65% participation percentage in the Pooling Arrangement for the foreseeable future. However, under applicable governance procedures, if the Pooling Arrangement were to be amended, management would make recommendations to the Independent Committees of the Board of Directors of both State Auto Mutual and STFC. The Independent Committees review and evaluate such factors as they deem relevant and recommend any appropriate pooling change to the Board of Directors of both State Auto Mutual and STFC subject to regulatory approval by each participant's respective domiciliary insurance department. The Pooling Arrangement is terminable by any of our Pooled Companies at any time by any party by giving twelve months' notice to the other parties and their respective domiciliary insurance departments. None of our Pooled Companies currently intends to terminate the Pooling Arrangement.

Under the terms of the Pooling Arrangement, all subject premiums, incurred losses, loss expenses and other underwriting expenses are prorated among our Pooled Companies on the basis of their participation in the pool. By spreading the underwriting risk, the Pooling Arrangement is designed to produce more uniform and stable underwriting results for each of our Pooled Companies than any one company would experience individually. This has the effect of providing each of our Pooled Companies with a similar mix of pooled property and casualty insurance business on a net basis.

## RESULTS OF OPERATIONS

### Summary

The following table sets forth certain key performance indicators we use to monitor our operations for the years ended December 31, 2012, 2011 and 2010:

<i>(\$ millions, except per share data)</i>	<b>2012</b>	2011 As adjusted <sup>(2)</sup>	2010 As adjusted <sup>(2)</sup>
<b>GAAP Basis:</b>			
Total revenues	<b>\$ 1,150.1</b>	1,553.7	1,355.1
Net income (loss)	<b>\$ 10.7</b>	(160.7)	24.4
Stockholders' equity	<b>\$ 737.2</b>	723.8	831.2
Book value per share	<b>\$ 18.22</b>	17.95	20.71
Return on average equity	<b>1.5</b>	(20.7)	2.9
Debt to capital ratio	<b>13.6</b>	13.9	12.3
Cat loss and ALAE ratio	<b>6.4</b>	16.2	7.9
Non-cat loss and LAE ratio	<b>68.3</b>	66.4	62.9
Loss and LAE ratio	<b>74.7</b>	82.6	70.8
Expense ratio	<b>33.2</b>	33.9	33.8
Combined ratio	<b>107.9</b>	116.5	104.6
Premiums written growth <sup>(1)</sup>	<b>(17.8)%</b>	(2.9)	9.3
Investment yield	<b>3.5%</b>	3.6	3.6
<b>SAP Basis:</b>			
Cat loss and ALAE points	<b>6.4</b>	16.2	7.9
Non-cat loss and ALAE	<b>61.7</b>	60.3	57.1
ULAE	<b>6.7</b>	5.9	5.3
Loss and LAE ratio	<b>74.8</b>	82.4	70.3
Expense ratio	<b>33.6</b>	33.9	32.9
Combined ratio	<b>108.4</b>	116.3	103.2
Net premiums written to surplus	<b>1.7</b>	2.2	1.7

(1) Year 2011 includes (a) an increase of 2.6 points related to the one-time \$34.1 million transfer of unearned premiums by the Rockhill Insurers in conjunction with the 1.1.11 pool change (b) a decrease of 8.1 points related to the one-time \$106.8 million transfer of unearned premiums to the Mutual Pooled Companies in conjunction with the 12.31.11 pool change, and (c) a decrease of 8.0 points, related to the one-time transfer of \$106.3 of unearned premiums on December 31, 2011 related to the HO QS Arrangement. Year 2010 includes a decrease of 0.2 points related to the one-time \$1.4 million transfer of unearned premiums to the Mutual Pooled Companies on January 1, 2010, in conjunction with the 2010 pool changes.

(2) As previously reported, we adopted with retrospective application at January 1, 2012 Accounting Standards Update 2010-26, Accounting for Costs Associated with Acquiring and Renewing Insurance Contracts. All applicable prior period amounts have been adjusted to conform to current period presentation. See Critical Accounting Policies-Deferred Acquisition Costs included in Item 7 of this Form 10-K.





**2012 Summary**

Our 2012 net income was \$10.7 million compared to a net loss of \$160.7 million in 2011 and net income of \$24.4 million in 2010. Our 2011 net loss included a non-cash charge of \$103.3 million related to a valuation allowance against our net deferred tax asset.

Our 2012 revenues were \$1,150.1 million compared to revenues of \$1,553.7 million in 2011 and \$1,355.1 million in 2010. Our 2012 expenses were \$1,139.5 compared to expenses of \$1,665.8 million in 2011 and \$1,330.7 million in 2010. The decline in revenues from 2011 to 2012 is attributed to the HO QS Arrangement (discussed below) and the 12.31.11 pool change (discussed above).

The following highlights significant factors that impacted 2012 results as compared to 2011 and 2010:

Earned premiums in 2012 were \$1,042.1 million compared to \$1,428.8 million and \$1,257.2 million in 2011 and 2010, respectively. The HO QS Arrangement accounted for \$166.2 million and the 12.31.11 pool change contributed \$267.9 million of this decline. Excluding the impact of the HO QS Arrangement and 12.31.11 pool change, earned premium increased 4.1%<sup>(1)</sup>. This growth was driven by our business insurance and specialty segments. The business segment growth was principally driven by higher average new business premium, increased renewal pricing and a recovering economy. Also contributing to this growth was our termination of an umbrella quota share reinsurance arrangement as of July 1, 2012. The specialty segment growth was principally driven by the addition of new programs and increased rates in our Rockhill unit.

Our 2012 results reflected a significant decrease in weather-related catastrophe losses when compared to the same 2011 and 2010 results. Our 2012 catastrophe loss ratio was 6.4 loss ratio points compared to 16.2 loss ratio points and 7.9 loss ratio points for 2011 and 2010, respectively. The HO QS Arrangement benefitted the ratio by ceding catastrophe losses to our reinsurance partners. The 2011 results of our personal and business insurance segments reflected a record level of weather-related catastrophe losses, which impacted 32 of our operating states, including Hurricane Irene and devastating tornadoes in Tuscaloosa, Alabama and Joplin, Missouri.

Our SAP non-catastrophe loss and ALAE ratio for 2012 was 61.7 loss ratio points compared to 60.3 loss ratio points and 57.1 loss ratio points for the same 2011 and 2010 periods, respectively. Our 2012 non-catastrophe loss and ALAE ratio results were negatively impacted by the strengthening of loss reserves in our RED unit within our specialty insurance segment. The HO QS Arrangement increased our SAP non-catastrophe loss and ALAE ratio 2.3 points in 2012. Our 2011 non-catastrophe loss and ALAE ratio results were also negatively impacted by a higher level of non-catastrophe weather related losses, a higher number of large bodily injury claims and an increase in workers' compensation reserves on certain life time disability claims.

Net realized gains on investments were \$28.8 million in 2012, compared to \$38.1 million and \$11.0 million in 2011 and 2010, respectively. The level of realized gains in 2011 was driven by reducing our equity holdings to manage our risk parameters as well as selling select securities in anticipation of the cash transfers in connection with the 12.31.11 pool change and the HO QS Arrangement.

- (1) For the year ended December 31, 2012, the following table sets forth the reconciliation of as reported earned premiums to pro forma earned premiums that exclude the impact of the quota share reinsurance agreement covering our homeowners book of business. For the year ended December 31, 2011, the following table sets forth the reconciliation on a pro forma basis which assumes that the 12.31.11 pool change from 80% to 65% was in effect as of January 1, 2011.

(\$ in millions)	For the year ended December 31		
	2012	2011	% Change
<b>Earned Premiums:</b>			
As reported earned premiums	\$ 1,042.1	1,428.8	(27.1)%
HO QS Arrangement	166.2		
Sub-total Excluding HO QS	1,208.3	1,428.8	(15.4)%
Impact of 12.31.11 Pool Change		267.9	

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

<i>Pro forma earned premiums</i>	<b>\$ 1,208.3</b>	1,160.9	4.1%
----------------------------------	-------------------	---------	------

### *Insurance Segments*

Insurance industry regulators require our insurance subsidiaries to report their financial condition and results of operations using SAP. We use SAP financial results, along with industry standard financial measures determined on a SAP basis and certain measures determined on a GAAP basis, to internally monitor the performance of our insurance segments 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 this Item 7.

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

### *Use of Non-GAAP Financial Measures*

In the following discussion of the results of our insurance segments, we sometimes refer to GAAP financial measures in the context of as reported and to non-GAAP financial measures in the context of pro forma. These pro forma, or non-GAAP financial measures, may (i) exclude the impact of the HO QS Arrangement cession for the year ended December 31, 2012, (ii) exclude the one-time impact of the 1.1.11 pool change for the year ended December 31, 2011, (iii) exclude the impact of the 2010 pool changes, (iv) assumes the 12.31.11 pool change from an 80% to 65% participation percentage had been in effect as of January 1, 2010, and (v) exclude the impact of the RED underwriting results. We believe the use of these non-GAAP financial measures will enable investors to (a) better understand the significance the reinsurance arrangement cession is contributing to our reported results for the year ended December 31, 2012, and (b) perform a meaningful comparison of our results of operations for the year ended December 31, 2012 and 2011. We have also included Reconciliation Tables 1- 7 and Tables 1 6 for readers to better understand the use and calculation of these non-GAAP financial measures.

### *Homeowners Quota Share Arrangement*

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

For 2012, our GAAP and SAP underwriting loss was \$82.1 million and \$92.0 million, respectively. The HO QS Arrangement improved our GAAP net underwriting loss by \$6.0 million (or 0.7 points increase on our GAAP combined ratio) (see Reconciliation Table 1), and our SAP underwriting loss by \$7.8 million (or 0.7 points increase on our SAP combined ratio) (see Reconciliation Table 2).

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

The following table sets forth, on a GAAP and pro forma basis, certain of our key performance indicators before and after the impact of the HO QS Arrangement cession for the year ended December 31, 2012.

Reconciliation Table 1

For the year ended December 31, 2012 (\$ millions)	GAAP HO QS Arrangement Cession - Overall Results		
	As Reported	HO QS Cession	Pro Forma without HO QS Cession
Earned premiums	\$ 1,042.1	\$ 166.2	\$ 1,208.3
Losses and LAE incurred:			
Cat loss and ALAE	67.1	49.5	116.6
Non-cat loss and LAE	711.2	74.5	785.7
<i>Total Loss and LAE incurred</i>	778.3	124.0	902.3
Acquisition and operating expenses	345.9	48.2	394.1
<i>Net underwriting loss</i>	\$ (82.1)	\$ (6.0)	\$ (88.1)
Cat loss and ALAE ratio	6.4%	29.8%	9.6%
Non-cat loss and LAE ratio	68.3%	44.8%	65.0%
<i>Total Loss and LAE ratio</i>	74.7%	74.6%	74.6%
Expense ratio	33.2%	29.0%	32.6%
<i>Combined ratio</i>	107.9%	103.6%	107.2%

The following table sets forth, on a SAP and pro forma basis, certain of our key performance indicators before and after the impact of the HO QS Arrangement cession for the year ended December 31, 2012.

Reconciliation Table 2

For the year ended December 31, 2012 (\$ millions)	SAP HO QS Arrangement Cession Overall Results		
	As Reported	HO QS Cession	Pro Forma without HO QS Cession
Net written premiums	\$ 1,055.3	\$ 172.3	\$ 1,227.6
Earned premiums	1,042.1	166.2	1,208.3
Losses and LAE incurred:			
Cat loss and ALAE	67.1	49.5	116.6
Non-cat loss and ALAE	643.0	74.5	717.5
<i>Total Loss and ALAE</i>	710.1	124.0	834.1
ULAE	68.9		68.9
<i>Total Loss and ALAE incurred</i>	779.0	124.0	903.0
Underwriting expenses	355.1	50.0	405.1
<i>Net underwriting loss</i>	\$ (92.0)	\$ (7.8)	\$ (99.8)
Cat loss and ALAE ratio	6.4%	29.8%	9.6%
Non-cat loss and ALAE ratio	61.7%	44.8%	59.4%

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

<i>Total loss and ALAE ratio</i>	68.1%	74.6%	69.0%
ULAE ratio	6.7%	0.0%	5.7%
<i>Total loss and LAE ratio</i>	74.8%	74.6%	74.7%
Expense ratio	33.6%	29.0%	33.0%
Combined ratio	108.4%	103.6%	107.7%

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

See additional pro forma reconciliation tables for the HO QS Arrangement cession on our personal insurance segment's SAP underwriting results at Reconciliation Table 5 and our homeowners' line of business at Reconciliation Table 6.

### Summary of Key Indicators of Insurance Segment Results

The following table sets forth certain key performance indicators for our insurance segments for the years ended December 31, 2012, 2011 and 2010:

(\$ millions)

	2012		2011		2010		2009	
	%	%	%	%	%	%	%	%
	Personal <sup>(1)</sup>	Ratio	Business	Ratio	Specialty	Ratio	Total <sup>(2)</sup>	Ratio
Written premiums <sup>(1)</sup>	\$ 469.5		\$ 349.4		\$ 236.4		\$ 1,055.3	
Earned premiums	469.8		327.2		245.1		1,042.1	
Cat loss and ALAE	26.9	5.7	37.8	11.5	2.4	1.0	67.1	6.4
Non-cat loss and ALAE	276.7	58.9	165.7	50.7	200.6	81.8	643.0	61.7
ULAE	41.2	8.8	19.0	5.8	8.7	3.5	68.9	6.7
Underwriting expenses <sup>(2)</sup>	126.6	27.0	147.0	42.1	81.5	34.4	355.1	33.6
SAP underwriting loss and SAP combined ratio	\$ (1.6)	100.4	\$ (42.3)	110.1	\$ (48.1)	120.7	\$ (92.0)	108.4

(\$ millions)

	2011		2010		2009		2008	
	%	%	%	%	%	%	%	%
	Personal	Ratio	Business	Ratio	Specialty	Ratio	Total	Ratio
Written premiums <sup>(3)</sup>	\$ 647.4		\$ 341.7		\$ 295.5		\$ 1,284.6	
Earned premiums	800.6		379.0		249.2		1,428.8	
Cat loss and ALAE	178.9	22.3	51.6	13.6	0.6	0.2	231.1	16.2
Non-cat loss and ALAE	469.1	58.6	220.2	58.1	172.4	69.2	861.7	60.3
ULAE	50.9	6.4	24.6	6.5	9.4	3.8	84.9	5.9
Underwriting expenses	169.1	26.1	153.5	44.9	113.4	38.4	436.0	33.9
SAP underwriting loss and SAP combined ratio	\$ (67.4)	113.4	\$ (70.9)	123.1	\$ (46.6)	111.6	\$ (184.9)	116.3

(\$ millions)

	2010		2009		2008		2007	
	%	%	%	%	%	%	%	%
	Personal	Ratio	Business	Ratio	Specialty	Ratio	Total	Ratio
Written premiums <sup>(4)</sup>	\$ 819.9		\$ 377.3		\$ 126.3		\$ 1,323.5	
Earned premiums	798.5		383.5		75.2		1,257.2	
Cat loss and ALAE	74.0	9.3	25.0	6.5			99.0	7.9
Non-cat loss and ALAE	454.7	56.9	215.5	56.2	46.9	62.5	717.1	57.1
ULAE	40.7	5.1	20.2	5.3	6.2	8.2	67.1	5.3
Underwriting expenses	238.4	29.1	146.8	38.9	50.6	40.0	435.8	32.9
SAP underwriting loss and SAP combined ratio	\$ (9.3)	100.4	\$ (24.0)	106.9	\$ (28.5)	110.7	\$ (61.8)	103.2

(1) See Reconciliation Table 5 for the impact of the HO QS Arrangement cession on the SAP personal insurance segment's SAP underwriting results.

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

- (2) See Reconciliation Table 2 for the impact of the HO QS Arrangement cession on our SAP underwriting results.
- (3) Includes:
- a. The one-time transfer of \$34.1 million of unearned premiums by the Rockhill Insurers to our specialty insurance segment in conjunction with the 1.1.11 pool change. In connection with this unearned premium transfer, we paid a one-time ceding commission of \$8.3 million to the Rockhill Insurers.
  - b. The one-time transfer of \$106.8 million of unearned premiums by the STFC Pooled Companies to the Mutual Pooled Companies in conjunction with the 12.31.11 pool change (transfer of \$43.4 million, \$35.6 million and \$27.8 million, respectively, from our personal insurance, business insurance and specialty insurance segments). In connection with this unearned premium transfer, we recognized a one-time ceding commission of \$27.3 million from the Mutual Pooled Companies (\$9.1 million, \$9.6 million and \$8.6 million, respectively, to our personal insurance, business insurance and specialty insurance segments).
  - c. The one-time transfer of \$106.3 million of unearned premiums by the STFC Pooled Companies on December 31, 2011 related to the HO QS Arrangement (from our personal insurance segment). In connection with this transfer we recognized a ceding commission of \$30.8 million.
  - d. Combined, these transactions impacted our personal insurance, business insurance and specialty insurance segments' statutory expense ratio by (0.1) points, 1.7 points and (0.9) points, respectively, and increased the total expense ratio by 0.7 points. See previous discussion regarding differences between GAAP and SAP.
- (4) Includes the one-time transfer of \$1.4 million of unearned premiums to the Mutual Pooled Companies on January 1, 2010, in conjunction with the 2010 pool changes (transfer of \$2.1 million of our personal insurance segment and receipt of \$0.7 million for the Mutual Pooled Companies' business insurance segment).



Revenue

We measure our top-line growth for our insurance segments based on net written premiums, which 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 year ended December 31, 2011, of the unearned premiums transferred by the Rockhill Insurers to us on January 1, 2011, in conjunction with the 1.1.11 pool change and for the year ended December 31, 2011, on a pro forma basis which assumes that the 12.31.11 pool change from an 80% to 65% participation percentage had been in effect as of January 1, 2011:

Reconciliation Table 3

	Net Written Premiums Reconciliation Table From 80% to Pro Forma 65% Pro Forma							
	As Reported 2012 Net Written Premiums	As Reported 2011 Net Written Premiums	01.01.11 Pool Change Impact	2011 Net Written Premiums Excluding 01.01.11 Pool Change	12.31.11 UEP Transfer	2011 Net Written Premiums Excluding 12.31.11 UEP Transfer	12.31.11 Pool Change Impact	Pro Forma 12/31/11
<b>Personal insurance segment:</b>								
Personal auto	\$ 383.6	\$ 452.1	\$	\$ 452.1	\$ (32.4)	\$ 484.5	\$ (90.8)	\$ 393.7
Homeowners	56.5	163.5		163.5	(7.8)	171.3	(32.1)	139.2
Other personal	29.4	31.8		31.8	(3.2)	35.0	(6.6)	28.4
<b>Total personal</b>	<b>469.5</b>	<b>647.4</b>		<b>647.4</b>	<b>(43.4)</b>	<b>690.8</b>	<b>(129.5)</b>	<b>561.3</b>
<b>Business insurance segment:</b>								
Commercial auto	88.4	84.5		84.5	(8.5)	93.0	(17.5)	75.5
Commercial multi-peril	101.1	98.2		98.2	(10.3)	108.5	(20.4)	88.1
Fire & allied lines	75.6	83.0		83.0	(8.9)	91.9	(17.2)	74.7
Other & product liability	66.5	56.7		56.7	(5.9)	62.6	(11.7)	50.9
Other commercial	17.8	19.3		19.3	(2.0)	21.3	(4.0)	17.3
<b>Total business</b>	<b>349.4</b>	<b>341.7</b>		<b>341.7</b>	<b>(35.6)</b>	<b>377.3</b>	<b>(70.8)</b>	<b>306.5</b>
<b>Specialty insurance segment:</b>								
RED	67.9	128.4		128.4	(13.2)	141.6	(26.5)	115.1
Rockhill	99.7	91.7	24.3	67.4	(8.3)	75.7	(14.2)	61.5
Workers compensation	68.8	75.4	9.8	65.6	(6.3)	71.9	(13.5)	58.4
<b>Total specialty</b>	<b>236.4</b>	<b>295.5</b>	<b>34.1</b>	<b>261.4</b>	<b>(27.8)</b>	<b>289.2</b>	<b>(54.2)</b>	<b>235.0</b>
<b>Total net written premiums</b>	<b>\$ 1,055.3</b>	<b>\$ 1,284.6</b>	<b>\$ 34.1</b>	<b>\$ 1,250.5</b>	<b>\$ (106.8)</b>	<b>\$ 1,357.3</b>	<b>\$ (254.5)</b>	<b>\$ 1,102.8</b>

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

The following table sets forth the reconciliation of the one-time impact on net written premiums for the year ended December 31, 2010, of the unearned premiums transferred to the Mutual Pooled Companies on January 1, 2010, in conjunction with the 2010 pool changes and for the year ended December 31, 2010, on a pro forma basis which assumes that the 12.31.11 pool change from an 80% to 65% participation percentage had been in effect as of January 1, 2010:

Reconciliation Table 4

(\$ millions)	Net Written Premiums Reconciliation Table From 80% to Pro Forma 65%				
	As Reported 2010 Net Written Premiums	12.31.10 Pool Change Impact	Pro Forma 2010 Net Written Premiums Excluding 12.31.10 Pool Change	12.31.11 Pool Change Impact	Pro Forma 12/31/10
<b>Personal insurance segment:</b>					
Personal auto	\$ 517.1	\$ (2.1)	\$ 519.2	\$ (97.3)	\$ 421.9
Homeowners	268.8		268.8	(50.4)	218.4
Other personal	34.0		34.0	(6.4)	27.6
<i>Total personal</i>	819.9	(2.1)	822.0	(154.1)	667.9
<b>Business insurance segment:</b>					
Commercial auto	95.4		95.4	(17.8)	77.6
Commercial multi-peril	98.4		98.4	(18.4)	80.0
Fire & allied lines	95.3		95.3	(17.9)	77.4
Other & product liability	66.1		66.1	(12.4)	53.7
Other commercial	22.1		22.1	(4.2)	17.9
<i>Total business</i>	377.3		377.3	(70.7)	306.6
<b>Specialty insurance segment:</b>					
RED	83.9	0.7	83.2	(15.6)	67.6
Rockhill	3.5		3.5	(0.7)	2.8
Workers compensation	38.9		38.9	(7.3)	31.6
<i>Total specialty</i>	126.3	0.7	125.6	(23.6)	102.0
<i>Total net written premiums</i>	\$ 1,323.5	\$ (1.4)	\$ 1,324.9	\$ (248.4)	\$ 1,076.5

*Personal Insurance Segment*

The following table sets forth the net written premiums by major product line of business for our personal insurance segment for the year ended December 31, 2012 and on a pro forma basis for the years ended December 31, 2011 and 2010 (see Reconciliation Tables 3 and 4).

Table 1

(\$ millions)	2012 As Reported	2011 Pro Forma	2010 Pro Forma
<b>Personal Insurance Segment:</b>			

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

Net Written Premiums

Personal auto	\$	<b>383.6</b>	393.7	421.9
Homeowners		<b>56.5</b>	139.2	218.4
Other personal		<b>29.4</b>	28.4	27.6
<i>Total personal</i>	\$	<b>469.5</b>	561.3	667.9

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

The following table sets forth the SAP loss and ALAE ratios by major product line of business for our personal insurance segment with the catastrophe and non-catastrophe impact shown separately for the years ended December 31, 2012, 2011 and 2010:

Table 2

(\$ millions)

	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat loss Ratio	Total Loss and LAE Ratio
<b>Statutory Loss and LAE Ratios</b>							
<b>2012</b>							
Personal auto	\$ 382.0	\$ 10.7	\$ 242.5	\$ 253.2	2.8	63.4	66.2
Homeowners	59.7	8.5	23.2	31.7	14.3	38.9	53.2
Other personal	28.1	7.7	11.0	18.7	27.4	39.3	66.7
<i>Total personal</i>	\$ 469.8	\$ 26.9	\$ 276.7	\$ 303.6	5.7	58.9	64.6
ULAE				41.2			8.8
<i>Total Loss and LAE</i>	\$ 469.8	\$ 26.9	\$ 276.7	\$ 344.8	5.7	58.9	73.4
<b>2011</b>							
Personal auto	\$ 492.6	\$ 16.9	\$ 312.9	\$ 329.8	3.4	63.6	67.0
Homeowners	272.7	154.4	139.4	293.8	56.7	51.0	107.7
Other personal	35.3	7.6	16.8	24.4	21.4	47.9	69.3
<i>Total personal</i>	\$ 800.6	\$ 178.9	\$ 469.1	\$ 648.0	22.3	58.6	80.9
ULAE				50.9			6.4
<i>Total Loss and LAE</i>	\$ 800.6	\$ 178.9	\$ 469.1	\$ 698.9	22.3	58.6	87.3
<b>2010</b>							
Personal auto	\$ 508.1	\$ 6.6	\$ 308.1	\$ 314.7	1.3	60.6	61.9
Homeowners	257.3	62.6	133.5	196.1	24.3	51.9	76.2
Other personal	33.1	4.8	13.1	17.9	15.0	39.0	54.0
<i>Total personal</i>	\$ 798.5	\$ 74.0	\$ 454.7	\$ 528.7	9.3	56.9	66.2
ULAE				40.7			5.1
<i>Total Loss and LAE</i>	\$ 798.5	\$ 74.0	\$ 454.7	\$ 569.4	9.3	56.9	71.3

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

As reported personal insurance segment net written premiums for the year ended December 31, 2012 decreased 27.5% compared to as reported net written premiums for the same 2011 period (see Reconciliation Table 3). As reported personal insurance segment net written premiums for the year ended December 31, 2012 decreased 16.4% compared to pro forma net written premiums for the same 2011 period (see Table 1). This decrease in premiums was primarily due to the following changes in our personal auto and homeowners lines of business: (i) the reshaping of our geographic footprint; (ii) rate actions; and (iii) the HO QS Arrangement. In our personal insurance segment, the HO QS Arrangement decreased our SAP net underwriting loss by \$7.8 million and our SAP combined ratio by 0.8 points for the year ended December 31, 2012 (see Reconciliation Table 5).

The following table sets forth, on a SAP and pro forma basis, certain of our key performance indicators for our personal insurance segment before and after the impact of the HO QS Arrangement cession for the year ended December 31, 2012.

Reconciliation Table 5

For the year ended December 31, 2012	SAP HO QS Arrangement		
	Cession	Personal Insurance	Pro Forma without HO QS Cession
(\$ millions)	As Reported	HO QS Cession	HO QS Cession
Net written premiums	\$ 469.5	\$ 172.3	\$ 641.8
Earned premiums	469.8	166.2	636.0
Losses and LAE Incurred:			
Cat loss and ALAE	26.9	49.5	76.4
Non-cat loss and ALAE	276.7	74.5	351.2
<i>Total Loss and ALAE</i>	303.6	124.0	427.6
ULAE	41.2		41.2
<i>Total Loss and LAE incurred</i>	344.8	124.0	468.8
Underwriting expenses	126.6	50.0	176.6
<i>Net underwriting gain</i>	\$ (1.6)	\$ (7.8)	\$ (9.4)
Cat loss and ALAE ratio	5.7%	29.8%	12.0%
Non-cat loss and ALAE ratio	58.9%	44.8%	55.2%
<i>Total Loss and ALAE ratio</i>	64.6%	74.6%	67.2%
ULAE ratio	8.8%	0.0%	6.5%
<i>Total Loss and LAE ratio</i>	73.4%	74.6%	73.7%
Expense ratio	27.0%	29.0%	27.5%
<i>Combined ratio</i>	100.4%	103.6%	101.2%

Our personal insurance segment's SAP catastrophe loss and ALAE ratio for 2012 was 5.7 loss ratio points compared to 22.3 loss ratio points and 9.3 loss ratio points for 2011 and 2010, respectively (see Table 2). Cessions under the HO QS Arrangement reduced our personal insurance segment catastrophe losses by \$49.5 million in 2012 (see Reconciliation Table 5). In 2012, our catastrophe losses without the HO QS cession was \$76.4 million. The majority of the 2012 catastrophe losses were primarily related to wind and hail activity from a tornado, wind and hail activity in Louisville, Kentucky, and St. Louis, Missouri and wind activity from a storm in the Midwest and Mid-Atlantic states. In 2011, our catastrophe losses included losses arising from Hurricane Irene and the tornadoes in Tuscaloosa, Alabama and Joplin, Missouri, as well as other tornadoes and wind and hail storms. A majority of the losses generated from these catastrophes were concentrated in six states: Tennessee, Ohio, Missouri, Texas, North Carolina and Alabama. The severity of these storm losses was the highest in our history. During 2010, we were impacted by losses from 30 of the 33 storms that were classified as numbered catastrophes by PCS, including a series of spring storms with wind and hail in northern Ohio and a rash of floods in the Nashville, Tennessee area, both which affected our auto physical damage results in both personal

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

and business insurance auto lines.

As reported personal auto net written premiums for the year ended December 31, 2012 decreased 15.2% compared to as reported net written premiums for the same 2011 period (see Reconciliation Table 3). As reported personal auto net written premiums for the year ended December 31, 2012 decreased 2.6% compared to pro forma net written premiums for the same 2011 period (see Table 1). This decrease in premiums was primarily due to (i) the reshaping of our geographic footprint to de-emphasize the Midwest and Southeast and to grow in areas less prone to wind damage, and (ii) actions taken in our homeowners book of business (discussed

below) which have impacted our companion home/auto policies. Even with this decline in overall personal auto net written premiums, we have continued to achieve premium growth in several states such as Texas, Colorado, Connecticut and Georgia. In addition, we have produced personal auto premium growth in underpenetrated states, such as Illinois and Michigan. We continue to aggressively address our rate needs in the personal auto line of business and have filed rate increases in the mid-single digit range to offset loss cost trends, primarily relating to bodily injury claims. The personal auto SAP non-cat loss ratio for the year ended December 31, 2012 improved slightly compared to this ratio for the same 2011 period primarily due to the factors discussed above.

As reported personal auto net written premiums for the year ended December 31, 2011 decreased 12.6% compared to as reported net written premiums for the same 2010 period (see Reconciliation Tables 3 and 4). Pro forma personal auto net written premiums for the year ended December 31, 2011 decreased 6.7% compared to pro forma net written premiums for the same 2010 period (see Table 1). This decrease in premiums was primarily impacted by the sale of our nonstandard automobile insurance subsidiary in 2010. The personal auto SAP non-cat loss ratio for the year ended December 31, 2011 increased 3.0 points compared to this ratio for the same 2010 period. The increase in this ratio was primarily due to increases in liability claim frequency, including an increase in the number of large losses.

As reported homeowners net written premiums was \$56.5 million for the year ended December 31, 2012 compared to as reported net written premiums of \$163.5 million for the same 2011 period (see Reconciliation Table 3). As reported homeowners net written premiums decreased \$82.7 million for the year ended December 31, 2012 compared to pro forma net written premiums for the same 2011 period (see Table 1). This decrease in premiums was primarily due to the HO QS Arrangement. Net written premiums ceded under the HO QS Arrangement were \$172.3 million in 2012. For the year ended December 31, 2012, homeowners net written premiums excluding the impact of the HO QS Arrangement was \$228.8 million (Reconciliation Table 6) compared to \$139.2 million in 2011 (Table 1). At December 31, 2011 under the HO QS Arrangement, the State Auto Group ceded 75% of its unearned premiums (\$86.4 million pro forma) in force to the reinsurers, which impacted our net written premiums by the same amount.

As reported homeowners net written premiums for the year ended December 31, 2011 decreased 39.2% compared to as reported net written premiums for the same 2010 period (see Reconciliation Tables 3 and 4). Pro forma homeowners net written premiums for the year ended December 31, 2011 decreased 36.3% compared to pro forma net written premiums for the same 2010 period (see Table 1). This decrease in premiums was primarily due to the HO QS Arrangement. During 2011 and 2010, we experienced declines in our policy counts from our core states of Ohio, Kentucky, and Indiana but also experienced policy count growth in states that we have either expanded into or identified as profitable growth opportunities.

The following table sets forth, on a SAP and pro forma basis, certain of our key performance indicators for the homeowners line of business before and after the impact of the HO QS Arrangement cession for the year ended December 31, 2012.

Reconciliation Table 6

For the year ended December 31, 2012	SAP HO QS Arrangement Cession Homeowners		
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession
<i>(\$ millions)</i>			
Net written premiums	\$ 56.5	\$ 172.3	\$ 228.8
Earned premiums	59.7	166.2	225.9
Losses and LAE incurred:			
Cat loss and ALAE	8.5	49.5	58.0
Non-cat loss and ALAE	23.2	74.5	97.7
<i>Total Loss and ALAE incurred</i>	\$ 31.7	\$ 124.0	\$ 155.7
Cat loss and ALAE ratio	14.3%	29.8%	25.7%
Non-cat loss and ALAE ratio	38.9%	44.8%	43.2%
<i>Total Loss and ALAE ratio</i>	53.2%	74.6%	68.9%

For the year ended December 31, 2012, the HO QS Arrangement improved our homeowners SAP loss and ALAE ratio by 15.7 points, with catastrophe losses accounting for 11.4 points of this improvement. In addition, we experienced improvement due to favorable development from

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

events that occurred prior to the inception of the HO QS Arrangement. Events occurring on or prior to December 31, 2011 are excluded from the HO QS Arrangement.

The homeowners SAP non-cat loss ratio for the year ended December 31, 2012 was 38.9%, an improvement of 12.1 points compared to the same 2011 period (see Table 2). Our non-catastrophe loss ratio improved as a result of prior year rate actions emerging in earned premiums. We continued to aggressively address our rate needs in the homeowners book of business in 2012



receiving regulatory approval to implement rate increases averaging approximately 15% in 26 of 28 of the states we write homeowners business in ( active states ) during 2012. In general, the most wind and adverse weather-prone states are receiving higher rate and deductible increases. The homeowners SAP non-cat loss ratio for the year ended December 31, 2011 slightly declined 0.9 points from the same 2010 period (see Table 2).

In addition to rate increases, we continue to utilize the following additional strategies to improve our homeowners results.

**CustomFit<sup>SM</sup> homeowners:** We have implemented the use of our by-peril rating approach, CustomFit homeowners, in states that represent approximately 80% of our homeowners premium and 86% of our five-year wind/hail losses. During 2012, our CustomFit homeowners was operational in 20 of our 28 active states. During 2012, we developed a second generation CustomFit homeowners product, which enhances our ability to model non-weather related losses. This second generation of CustomFit homeowners was deployed in 2 active states in late 2012.

**Evaluating, monitoring and terminating unprofitable agencies:** We are aggressively evaluating and monitoring unprofitable agencies, which includes reviewing existing policies, implementing tighter new business and renewal guidelines, and applying other loss mitigation tools. In 2012, we terminated the personal lines relationship with a significant number of agencies in our most unprofitable homeowners states.

**Insurance to value:** We continue to focus on insurance to value so that our insureds maintain an amount of coverage sufficient to replace their home and contents in the case of a total loss. Proper insurance to value ensures that our premiums are commensurate with our loss exposure.

**Wind and hail deductibles:** We have implemented mandatory wind and hail deductibles in all targeted catastrophe prone states. We continue to evaluate the implementation of this loss mitigation tool in other states based upon annual rate reviews.

*Business Insurance Segment*

The following table sets forth the net written premiums by major product line of business for our business insurance segment for the year ended December 31, 2012 and on a pro forma basis for the years ended December 31, 2011 and 2010 (see Reconciliation Tables 3 and 4).

Table 3

<i>(\$ millions)</i>	<b>2012</b>	2011	2010
	<b>As Reported</b>	Pro Forma	Pro Forma
<b><u>Business Insurance Segment:</u></b>			
<b><u>Net Written Premiums</u></b>			
Commercial auto	<b>\$ 88.4</b>	75.5	77.6
Commercial multi-peril	<b>101.1</b>	88.1	80.0
Fire & allied lines	<b>75.6</b>	74.7	77.4
Other & product liability	<b>66.5</b>	50.9	53.7
Other commercial	<b>17.8</b>	17.3	17.9
<i>Total business</i>	<b>\$ 349.4</b>	306.5	306.6

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

The following table sets forth the SAP loss and ALAE ratios by major product line of business for our business insurance segment with the catastrophe and non-catastrophe impact shown separately for the years ended December 31, 2012, 2011 and 2010:

Table 4

(\$ millions)

	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat loss Ratio	Total Loss and LAE Ratio
<b>Statutory Loss and LAE Ratios</b>							
<b>2012</b>							
Business insurance segment:							
Commercial auto	\$ 81.4	\$ 0.7	\$ 51.6	\$ 52.3	0.9	63.3	64.2
Commercial multi-peril	94.3	13.0	52.8	65.8	13.8	55.9	69.7
Fire & allied lines	74.5	23.8	22.9	46.7	31.9	30.8	62.7
Other & product liability	59.3		33.6	33.6		56.8	56.8
Other commercial	17.7	0.3	4.8	5.1	1.3	27.3	28.6
<i>Total business</i>	\$ 327.2	\$ 37.8	\$ 165.7	\$ 203.5	11.5	50.7	62.2
ULAE				19.0			5.8
<i>Total Loss and LAE</i>	\$ 327.2	\$ 37.8	\$ 165.7	\$ 222.5	11.5	50.7	68.0
<b>2011</b>							
Business insurance segment:							
Commercial auto	\$ 94.0	\$ 2.7	\$ 56.4	\$ 59.1	2.8	60.1	62.9
Commercial multi-peril	104.1	21.6	52.1	73.7	20.7	50.0	70.7
Fire & allied lines	93.8	26.7	51.1	77.8	28.5	54.4	82.9
Other & product liability	65.4		53.8	53.8		82.2	82.2
Other commercial	21.7	0.6	6.8	7.4	2.8	31.2	34.0
<i>Total business</i>	\$ 379.0	\$ 51.6	\$ 220.2	\$ 271.8	13.6	58.1	71.7
ULAE				24.6			6.5
<i>Total Loss and LAE</i>	\$ 379.0	\$ 51.6	\$ 220.2	\$ 296.4	13.6	58.1	78.2
<b>2010</b>							
Business insurance segment:							
Commercial auto	\$ 98.6	\$ 1.5	\$ 55.8	\$ 57.3	1.5	56.6	58.1
Commercial multi-peril	95.6	7.4	46.5	53.9	7.7	48.6	56.3
Fire & allied lines	97.7	15.6	51.0	66.6	16.0	52.1	68.1
Other & product liability	69.0		54.0	54.0		78.4	78.4
Other commercial	22.6	0.5	8.2	8.7	2.3	35.7	38.0
<i>Total business</i>	\$ 383.5	\$ 25.0	\$ 215.5	\$ 240.5	6.5	56.2	62.7
ULAE				20.2			5.3
<i>Total Loss and LAE</i>	\$ 383.5	\$ 25.0	\$ 215.5	\$ 260.7	6.5	56.2	68.0

As reported business insurance segment net written premiums for the year ended December 31, 2012 increased 2.3% compared to as reported net written premiums for the same 2011 period (see Reconciliation Table 3). As reported business insurance segment net written premiums for the year ended December 31, 2012 increased by 14.0% compared to pro forma net written premiums for the same 2011 period (see Table 3). This increase in premiums was primarily due to our (i) writing larger average premium new business accounts, (ii) receiving modest pricing increases on renewal business, and (iii) experiencing more growth on existing policies due to improved economic conditions. Additionally,

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

business insurance segment net written premiums included \$7.2 million of unearned premiums transferred as the result of terminating an umbrella quota share reinsurance arrangement as of July 1, 2012. For the year ended December 31, 2011, written premiums of \$13.5 million were ceded under the umbrella treaty. For the year ended December 31, 2012, the termination of this umbrella treaty accounted for 4.7 points of the 14.0% net written premium growth discussed above.

As reported business insurance segment net written premiums for the year ended December 31, 2011 decreased 9.4% compared to as reported net written premiums for the same 2010 period (see Reconciliation Tables 3 and 4). Pro forma business insurance net written premiums for the year ended December 31, 2011 were flat compared to pro forma net written premiums for the same 2010 period (see Table 3).

The business insurance segment's SAP non catastrophe loss and ALAE ratio for 2012 was 50.7 loss ratio points compared to 58.1 loss ratio points and 56.2 loss ratio points for 2011 and 2010, respectively (see Table 4). The decrease from 2011 to 2012 was primarily due to fewer large losses in our fire and allied and other & product liability lines. The increase from 2010 to 2011 was primarily due to an increase in weather-related losses in the fire & allied lines as well as an increase in the number of large losses attributable to a more active claims process whereby the ultimate liability was recognized earlier in the case reserving process.

The business insurance segment's catastrophe loss and ALAE ratio for 2012 was 11.5 loss ratio points compared to 13.6 loss ratio points and 6.5 loss ratio points for 2011 and 2010, respectively. We experienced a higher level of catastrophe losses in 2012 and 2011 as compared to 2010.

Our small accounts are a foundational element of our premium writings and will continue as an important part of our future business plans. Improved efficiency and reduced processing expense will be critical to our success managing these accounts. Business Insurance Evolution (BIE), introduced into two states in 2012, is an important tool providing automated predictive price models and rules engines as part of our new business and policy renewal process on our smaller accounts. BIE will allow this process to move from being high touch (i.e. very manual), to low or in many instances no touch processing. We intend to complete the integration of BIE into our remaining states in 2013 in our largest lines of business. We believe that over time the ability to price policies based on predictive criteria and issuing them more efficiently will produce an improvement in our loss ratio and expense ratio results, while increasing agent satisfaction. We anticipate profit improvement in our smaller account book of business beginning in 2014.

Our current book of business is mainly comprised of smaller commercial accounts that are less than \$5,000 in premium. Our goal in 2013 is to write larger, more complex accounts in the premium range of \$25,000-\$50,000. As these accounts are written frequently by independent agents, we have developed strategies which we believe will enable us to write a larger percentage of these accounts. We believe writing a greater mix of larger accounts will improve our expense ratio and provide value to our independent agencies.

Additionally, we are concentrating on accounts which produce \$100,000 or more in premium. These large accounts will typically have over \$3.0 million of payroll and more than \$25.0 million in sales. We believe our risk consulting and claims management will provide value to our independent agents in writing these larger accounts.

#### *Specialty Insurance Segment*

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.

The following table sets forth the net written premiums by unit for our specialty insurance segment for the year ended December 31, 2012 and on a pro forma basis for the years ended December 31, 2011 and 2010 (see Reconciliation Tables 3 and 4).

Table 5

(\$ millions)

	2012 As Reported	2011 Pro Forma	2010 Pro Forma
<i><u>Specialty Insurance Segment:</u></i>			
<i><u>Net Written Premiums</u></i>			
RED	\$ 67.9	115.1	67.6
Rockhill	99.7	61.5	2.8
Workers compensation	68.8	58.4	31.6
<i>Total specialty</i>	\$ 236.4	235.0	102.0

As reported specialty insurance segment net written premiums for the year ended December 31, 2012 decreased 20.0% compared to as reported net written premiums for the same 2011 period (see Reconciliation Table 3). As reported specialty insurance segment net written premiums for the year ended December 31, 2012 increased by 0.6% compared to pro forma net written premiums for the same 2011 period (see Table 5). Pro Forma specialty insurance segment net written premiums for the year ended December 31, 2011 increased 130.4% compared to the pro forma

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

net written premiums for the same 2010 period (see Table 5).

For our Rockhill unit, as reported net written premiums for the year ended December 31, 2012 increased 8.7% compared to as reported net written premiums for the same 2011 period (see Reconciliation Table 3), and as reported net written premiums for the year ended December 31, 2012 increased 62.1% compared to pro forma net written premiums for the same 2011 period (see Table 5). The increase was impacted by the following.

Growth driven by the addition of six new programs generated through managing general underwriters. These new programs accounted for \$14.6 million of the premium growth for the year ended December 31, 2012;

Changes in the structure of two liability lines and all other perils reinsurance programs made in 2011, which resulted in our retaining additional written premium of \$6.5 million for the year ended December 31, 2012;

Significant rate increases in our property business and increased business opportunities through our excess and surplus channel for catastrophe exposed businesses due to recent global catastrophe events and recent industry catastrophe model changes. This business is written on a non-admitted basis, which allows us to underwrite unique insurance requirements using customized rates and forms, and is subject to a separate catastrophe treaty with a net retention of \$9.75 million for each occurrence; and

Exposure growth in our excess and surplus casualty lines, which we believe was attributable to early signs of stabilization in pricing in the commercial lines market and the strengthening of broker relationships and marketing initiatives.

For our Rockhill unit, as reported net written premiums for the year ended December 31, 2011 increased \$88.2 million compared to as reported net written premiums for the same 2010 period (see Reconciliation Tables 3 and 4). The premium growth in our Rockhill unit was primarily due to the addition of the Rockhill Insurers' business into the Pooling Arrangement in 2011.

For our workers' compensation unit, as reported net written premiums for the year ended December 31, 2012 decreased 8.8% compared to as reported net written premiums for the same 2011 period (see Reconciliation Table 3), and as reported net written premiums for the year ended December 31, 2012 increased 17.8% compared to pro forma net written premiums for the same 2011 period (see Table 5). The premium growth in our workers' compensation unit was driven by increases in our mono-line product due primarily to state expansion and a firming market place along with growth in our small account workers' compensation product written in conjunction with our standard business products.

For our workers' compensation unit, as reported net written premiums for the year ended December 31, 2011 increased 93.8% compared to as reported net written premiums for the same 2010 period (see Reconciliation Tables 3 and 4). The net written premium growth in the workers' compensation unit was primarily due to the addition of the Rockhill Insurers' business into the Pooling Arrangement in 2011. Pro forma workers' compensation unit net written premiums for the year ended December 31, 2011 increased 84.8% compared to pro forma net written premiums for the same 2010 period (see Table 5).

For our RED unit, as reported net written premiums for the year ended December 31, 2012 decreased 47.1% compared to as reported net written premiums for the same 2011 period (see Reconciliation Table 3) and as reported net written premiums for the year ended December 31, 2012 decreased 41.0% compared to pro forma net written premiums for the same 2011 period (see Table 5). The decrease in net written premiums was primarily due to the cancelation of substantially all RED programs.

The specialty insurance segment produced net underwriting losses for the year ended December 31, 2012, of \$48.1 million (see Reconciliation Table 7), due to the unprofitable performance of the RED unit. In our specialty insurance segment, RED underwriting results increased our SAP net underwriting loss by \$49.3 million and increased our SAP combined ratio by 26.2 points for the year ended December 31, 2012 (see Reconciliation Table 7). The total specialty insurance segment SAP non catastrophe loss and ALAE ratio for year ended December 31, 2012 increased 12.6 points from the same 2011 period (see Table 6) primarily due to \$30.5 million of loss and loss expense reserve strengthening within our RED unit principally related to a large commercial auto trucking program and a sizeable commercial restaurant program, which were cancelled in 2012. As previously disclosed, we have reorganized and merged the operations of RED into the Rockhill unit's program division and have terminated or sent notice of termination representing substantially all of the business written by the former management team of RED. We will continue writing program business through the Rockhill unit.

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

The following table sets forth, on a SAP and pro forma basis, certain of our key performance indicators for our specialty insurance segment before and after the impact of the RED underwriting results for the year ended December 31, 2012.

Reconciliation Table 7

For the year ended December 31, 2012 <i>(\$ millions)</i>	SAP Underwriting Results Specialty Insurance		
	As Reported	RED	Pro Forma without RED
Net written premiums	\$ 236.4	\$ 67.9	\$ 168.5
Earned premiums	245.1	97.9	147.2
Losses and LAE incurred:			
Cat loss and ALAE	2.4	0.7	1.7
Non-cat loss and ALAE	200.6	114.9	85.7
<i>Total Loss and ALAE</i>	203.0	115.6	87.4
ULAE	8.7	4.6	4.1
<i>Total Loss and LAE incurred</i>	211.7	120.2	91.5
Acquisition and operating expenses	81.5	27.0	54.5
<i>Net underwriting loss</i>	\$ (48.1)	\$ (49.3)	\$ 1.2
Cat loss and ALAE ratio	1.0%	0.7%	1.1%
Non-cat loss and ALAE ratio	81.8%	117.4%	58.3%
<i>Total Loss and ALAE ratio</i>	82.8%	118.1%	59.4%
ULAE ratio	3.5%	4.7%	2.8%
<i>Total Loss and LAE ratio</i>	86.3%	122.8%	62.2%
Expense ratio	34.4%	39.8%	32.3%
<i>Combined ratio</i>	120.7%	162.6%	94.5%

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

The following table sets forth the SAP loss and LAE ratios for our specialty insurance segment with the catastrophe and non-catastrophe impact shown separately for the years ended December 31, 2012, 2011 and 2010:

Table 6

(\$ millions)

	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat loss Ratio	Total Loss and LAE Ratio
<b>Statutory Loss and LAE Ratios</b>							
Specialty insurance segment:							
<b>2012</b>	<b>\$ 245.1</b>	<b>\$ 2.4</b>	<b>\$ 200.6</b>	<b>\$ 203.0</b>	<b>1.0</b>	<b>81.8</b>	<b>82.8</b>
ULAE				8.7			3.5
<i>Total Loss and LAE</i>	<b>\$ 245.1</b>	<b>\$ 2.4</b>	<b>\$ 200.6</b>	<b>\$ 211.7</b>	<b>1.0</b>	<b>81.8</b>	<b>86.3</b>
2011	\$ 249.2	\$ 0.6	\$ 172.4	\$ 173.0	0.2	69.2	69.4
ULAE				9.4			3.8
<i>Total Loss and LAE</i>	\$ 249.2	\$ 0.6	\$ 172.4	\$ 182.4	0.2	69.2	73.2
2010	\$ 75.2		\$ 46.9	\$ 46.9		62.5	62.5
ULAE				6.2			8.2
<i>Total Loss and LAE</i>	\$ 75.2		\$ 46.9	\$ 53.1		62.5	70.7

In the specialty insurance segment, the total SAP non-cat loss ratio for year ended December 31, 2011 increased 6.7 points from the same 2010 period (see Table 6). The increase was primarily driven by an increase in reserves of \$5.4 million in certain life time disability claims in the workers' compensation line of business, nearly all of which are from 2009 and prior years, with approximately 65% from accident years 2006 and prior, as well as higher levels of losses in our RED commercial auto line of business.

*Loss and LAE Development*

Losses and loss expenses for a calendar year represent the combined estimated ultimate liability for claims occurring in the current calendar year along with any change in estimated ultimate liability for claims occurring in prior years. The following table sets forth the provision for losses and loss expenses for those claims occurring in the current and prior years, along with the GAAP loss and LAE ratio for the years ended December 31, 2012, 2011 and 2010:

	2012	% GAAP Loss and LAE	2011	% GAAP Loss and LAE	2010	% GAAP Loss and LAE
(\$ millions)						
Provision for losses and loss expenses occurring:						
Current year	\$ 795.2	76.3	\$ 1,213.3	84.9	\$ 954.2	75.9
Prior years	(16.9)	(1.6)	(33.3)	(2.3)	(64.6)	(5.1)
<i>Total losses and loss expenses</i>	<b>\$ 778.3</b>	<b>74.7</b>	<b>\$ 1,180.0</b>	<b>82.6</b>	<b>\$ 889.6</b>	<b>70.8</b>



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

As shown above, the 2012 loss and loss expenses attributable to prior years totaled a decrease of \$16.9 million, or favorable development, in the estimated ultimate liability for prior years' claims. The following table sets forth a tabular presentation of the favorable development by accident year for the year ended December 31, 2012:

<i>(\$ millions)</i>	Current Year
Accident Year	Development
	of Ultimate Liability <i>Redundancy / (Deficiency)</i>
2002 and prior	\$ 0.9
2003	0.2
2004	0.3
2005	-
2006	(0.1)
2007	2.4
2008	2.3
2009	4.9
2010	8.0
2011	(2.0)
<i>Total</i>	\$ 16.9

While emergence by accident year includes normal fluctuations due to the uncertainty associated with loss reserve development and claim settlement, the favorable development in 2012 came primarily from the accident years 2010 and 2009. The more notable items contributing to the 2012 favorable development were:

ULAE was \$6.3 million lower than anticipated in the reserves at December 31, 2011.

We experienced favorable catastrophe loss development of \$10.4 million in 2012 related to the higher level of catastrophe losses we experienced in 2011.

In the personal and business insurance segments, the non-catastrophe loss and ALAE reserves accounted for \$28.0 million of favorable development related to the latest three accident years, primarily in the personal auto liability, other & product liability, and fire & allied lines with \$10.5 million, \$9.4 million and \$5.1 million of the favorable development, respectively. The favorable development in these lines was driven by emergence of lower than anticipated claim severity.

In the specialty insurance segment, the non-catastrophe loss and ALAE reserves accounted for \$27.8 million of adverse development related to the latest two accident years, which was driven by RED reserve strengthening (discussed above).

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

As shown above, the 2011 loss and loss expenses attributable to prior years totaled a decrease of \$33.3 million, or favorable development, in the estimated ultimate liability for prior years' claims. The following table sets forth a tabular presentation of the favorable development by accident year for the year ended December 31, 2011:

<i>(\$ millions)</i>	Current Year
Accident Year	Development
	of Ultimate Liability <i>Redundancy / (Deficiency)</i>
2001 and prior	\$ 1.8
2002	0.7
2003	(0.2)
2004	2.5
2005	(2.3)
2006	0.9
2007	4.2
2008	5.1
2009	11.6
2010	9.0
<i>Total</i>	\$ 33.3

While emergence by accident year includes normal fluctuations due to the uncertainty associated with loss reserve development and claim settlement, the favorable development in 2011 came primarily from accident years 2009 and 2010. The more notable items contributing to the 2011 favorable development were:

ULAE was \$7.6 million lower than anticipated in the reserves at December 31, 2010.

Favorable catastrophe loss development of \$4.3 million was primarily within our fire & allied lines, other personal, personal auto and homeowners lines of business.

In the personal and business insurance segments, the non-catastrophe loss and ALAE reserves developed favorably by \$28.1 million, primarily in the property lines. Homeowners, commercial multi-peril and fire & allied lines reserves accounted for \$14.2 million, \$6.1 million and \$4.9 million of the favorable development, respectively. The favorable development in these lines was driven by emergence of lower than anticipated claim severity, primarily from accident year 2010 and, to a lesser extent, the past five accident years in the commercial multi-peril line of business.

In the specialty segment, the non-catastrophe loss and ALAE reserves developed adversely by \$6.7 million, which was driven by greater than anticipated large losses in the commercial auto line of business and reserve increases on certain life time disability claims in the workers' compensation line of business.

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

As shown above, the 2010 loss and loss expenses attributable to prior years totaled a decrease of \$64.6 million, or favorable development, in the estimated ultimate liability for prior years' claims. The following table sets forth a tabular presentation of the favorable development by accident year for the year ended December 31, 2010:

<i>(\$ millions)</i>	Current Year
Accident Year	Development
	of Ultimate Liability <i>Redundancy / (Deficiency)</i>
2000 and prior	\$ (0.5)
2001	(0.2)
2002	0.7
2003	0.1
2004	2.2
2005	1.4
2006	5.7
2007	2.0
2008	13.0
2009	40.2
<b>Total</b>	<b>\$ 64.6</b>

The favorable development in 2010 came primarily from accident year 2009 and 2008. The more notable items contributing to the 2010 favorable development were:

ULAE was \$12.7 million lower than anticipated in the reserves at December 31, 2009, with approximately 78% being attributable to the 2009 accident year.

Favorable catastrophe loss development of \$3.3 million was primarily associated with the 2009 accident year. This development occurred primarily within our homeowners and commercial multi-peril lines of business.

Favorable development in the auto liability, homeowners and fire & allied lines accounts for the majority of the development in the non-catastrophe reserves, with the balance spread across multiple lines of business. Standard, nonstandard and commercial auto liability reserves developed favorably by \$10.7 million. Homeowners and fire & allied reserves developed lower than anticipated by \$10.4 million and \$9.0 million, respectively. The favorable development in these lines of business was driven by emergence of lower than anticipated claim severity, as well as lower than anticipated claim frequency for fire & allied lines. The favorable development was primarily associated with the 2009 and, to a lesser extent, 2008 accident years.

See additional discussion regarding loss and loss expense reserves at the Critical Accounting Policies - Losses and Loss Expenses Payable section included in this Item 7.

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

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

(\$ millions)	December 31, 2012	December 31, 2011	\$ Change
<b>Personal insurance segment:</b>			
Personal auto	\$ 186.1	195.9	(9.8)
Homeowners	34.6	71.9	(37.3)
Other personal	10.3	11.2	(0.9)
<i>Total personal</i>	<b>231.0</b>	279.0	(48.0)
<b>Business insurance segment:</b>			
Commercial auto	77.4	76.9	0.5
Commercial multi-peril	80.4	73.5	6.9
Fire & allied lines	21.5	24.3	(2.8)
Other & product liability	159.6	158.6	1.0
Other business	2.9	3.6	(0.7)
<i>Total business</i>	<b>341.8</b>	336.9	4.9
<b>Specialty insurance segment</b>	<b>355.9</b>	265.7	90.2
<i>Total losses and loss expenses payable net of reinsurance recoverable on losses and loss expenses payable</i>	<b>\$ 928.7</b>	881.6	47.1

The loss and loss expenses payable at December 31, 2012 increased \$47.1 million from the loss and loss expenses payable at December 31, 2011. This increase was primarily due to earned premium growth in our specialty insurance segment and the corresponding increase in claims activity, as well as the previously mentioned loss and loss expense reserve strengthening with our RED unit. Our homeowners line of business declined \$37.3 million primarily due to the ceding of reserves to unaffiliated reinsurers in connection with the HO QS Arrangement. We conduct quarterly reviews of loss development reports and make judgments in determining the reserves for ultimate losses and loss expenses payable. Several factors are considered by us when estimating ultimate liabilities including consistency in relative case reserve adequacy, consistency in claims settlement practices, recent legal developments, historical data, actuarial projections, accounting projections, exposure changes, anticipated inflation, current business conditions, catastrophe developments, late reported claims, and other reasonableness tests.

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

### *Acquisition and Operating Expenses*

Our GAAP expense ratio was 33.2% in 2012 compared to 33.9% and 33.8% in 2011 and 2010, respectively.

### *Investment Operations Segment*

Our investment portfolio and the investment portfolios of other members of the State Auto Group are managed by our subsidiary, Stateco. Stateco utilizes its own personnel to invest in fixed maturities and large-cap equities and outside investment managers to invest in small-cap equities and international funds. The Investment Committee (the Committee) of our Board of Directors establishes the investment policies to be followed by Stateco. Our primary investment objectives are to maintain adequate liquidity and capital to meet our responsibilities to policyholders, grow long term economic surplus to increase our capital position, maintain a consistent level of income to support operations and manage investment risk. Our current investment strategy does not rely on the use of derivative financial instruments.

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

Our decision to make a specific investment is influenced primarily by the following factors: (a) investment risks; (b) general market conditions; (c) relative valuations of investment vehicles; (d) general market interest rates; (e) our liquidity requirements at any given time; and (f) our current federal income tax position and relative spread between after tax yields on tax exempt and taxable fixed maturity investments.

We have investment policy guidelines with respect to purchasing fixed maturity investments for our insurance subsidiaries which preclude investments in bonds that are rated below investment grade by a recognized rating service. For the insurance subsidiaries, the maximum investment in any single note or bond is limited to 5.0% or less of statutory assets, other than obligations of the U.S. government or government agencies, for which there is no limit. Our fixed maturity portfolio is composed of high quality, investment grade issues, comprised almost entirely of debt issues rated AAA or AA. At December 31, 2012, there were no fixed maturity investments rated below investment grade in our available-for-sale investment portfolio.

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

Our internally managed equity portfolio invests in U.S. large-cap, dividend-paying companies across many different industries selected based upon their potential for appreciation as well as ability to continue paying dividends. This diversification across companies and industries reduces volatility in the value of the large-cap equity portfolio. In addition, our investment policy guidelines limit the purchase of a specific stock to no more than 2% of the market value of the stock at the time of purchase, and no single equity holding should exceed 5% of the total equity portfolio.

Our externally managed equity portfolios invest in U.S. small-cap equities and international funds. These managers are permitted to manage the portfolios according to their own respective portfolio objectives. In selecting our outside investment managers we confirm that their portfolio objectives, including risk tolerance, are acceptable to us. However, there may be slight differences in their objectives with respect to dividend payments and other constraints that we apply to our large-cap equity holdings.

Diversifying our portfolio into small-cap equities and international equity funds was designed to achieve a greater total return with reduced volatility. We believe that in most market cycles, diversification of the portfolio will be beneficial to us, and we plan to continue to maintain a diversified portfolio.

At December 31, 2012, our investments in fixed maturities, equity securities and certain other invested assets were held as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are included as a separate component of stockholders' equity as accumulated other comprehensive income (loss) and as such are not included in the determination of net income (loss).

### *Composition of Investment Portfolio*

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

(\$ millions)	December 31, 2012	% of Total	December 31, 2011	% of Total
Cash and cash equivalents	\$ 59.0	2.5	\$ 356.0	13.8
Fixed maturities, at fair value:				
Fixed maturities	1,674.1	72.0	1,674.5	64.8
Treasury inflation-protected securities	231.0	9.9	260.4	10.1
<i>Total fixed maturities</i>	<b>1,905.1</b>	<b>81.9</b>	1,934.9	74.9
Notes receivable from affiliate <sup>(1)</sup>	70.0	3.0	70.0	2.7
Equity securities, at fair value:				
Large-cap securities	174.2	7.5	122.1	4.7
Small-cap securities	54.2	2.3	45.2	1.7
<i>Total equity securities</i>	<b>228.4</b>	<b>9.8</b>	167.3	6.4
Other invested assets, at fair value:				
International instruments	59.0	2.6	52.6	2.0
Other invested assets	5.4	0.2	4.6	0.2
<i>Total other invested assets, at fair value</i>	<b>64.4</b>	<b>2.8</b>	57.2	2.2
Other invested assets, at cost	0.5	0.0	0.5	0.0
<i>Total portfolio</i>	<b>\$ 2,327.4</b>	<b>100.0</b>	\$ 2,585.9	100.0

<sup>(1)</sup> 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.

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

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

<i>(\$ millions)</i>	Amortized	
	Cost	Fair Value
Due in 1 year or less	<b>\$ 47.3</b>	<b>47.9</b>
Due after 1 year through 5 years	<b>286.8</b>	<b>306.9</b>
Due after 5 years through 10 years	<b>463.4</b>	<b>502.9</b>
Due after 10 years	<b>601.6</b>	<b>647.7</b>
U.S. government agencies residential mortgage-backed securities	<b>377.1</b>	<b>399.7</b>
<i>Total</i>	<b>\$ 1,776.2</b>	<b>1,905.1</b>

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

At December 31, 2012, our equity portfolio consisted of approximately 47 different large-cap stocks and 83 small-cap stocks. The largest single position was 6.0% of the equity portfolio based on fair value, and the top ten positions accounted for 28.1% of the equity portfolio. At December 31, 2011, our equity portfolio consisted of approximately 51 different large-cap stocks and 72 small-cap stocks. The largest single position was 2.9% of the equity portfolio based on fair value and the top ten positions account for 22.5% of the equity portfolio. Since our equity portfolio consists primarily of large-cap value-oriented stocks, with a small allocation to small-cap equities, when large-cap stocks and/or value-oriented stocks perform well our equity portfolio typically performs well compared to benchmarks. Conversely, when growth stocks outperform value and/or small- to mid-cap stocks outperform large-cap stocks, our equity portfolio does not perform as well compared to benchmarks.

*Market Risk*

Our primary market risk exposures are to changes in market prices for equity securities and changes in interest rates and credit ratings for fixed maturity securities. Our fixed maturity securities are subject to interest rate risk whereby the value of the securities varies as market interest rates change. We manage this risk by closely monitoring the duration of the fixed maturity portfolio. The duration of the fixed maturity portfolio was approximately 4.05 and 3.71 as of December 31, 2012 and 2011, respectively. The following table sets forth our interest rate risk and the effects of a parallel change in interest rates on the fair value of the available-for-sale fixed maturity portfolio at December 31, 2012:

(\$ millions)	Fair Value				
	-200 bps	-100 bps	Actual	+100 bps	+200 bps
	Change	Change		Change	Change
<b>Fixed maturities:</b>					
U.S. treasury securities and obligations of U.S. government agencies	\$ 398.7	381.9	366.5	349.8	333.3
Obligations of states and political subdivisions	866.9	833.2	800.3	766.0	728.5
Corporate securities	371.2	354.9	338.6	322.4	307.3
U.S. government agencies residential mortgage-backed securities	401.6	403.7	399.7	391.1	379.0
<i>Balance as of December 31, 2012</i>	\$ 2,038.4	1,973.7	1,905.1	1,829.3	1,748.1

This table summarizes only the effects that a parallel change in interest rates could have on the fixed maturity portfolio. Changes in rates would also change the value of our liabilities and possibly other financial assets. We caution the reader that this analysis does not take into account nonparallel changes in interest rates. It is likely that some rates would increase or decrease more than others depending upon market conditions at the time of the change. This nonparallel change would alter the value of the fixed maturity portfolio. The analysis is also limited in that it does not take into account any actions that might be taken by us in response to these changes. As a result, the actual impact of a change in interest rates and the resulting fixed maturity values may differ significantly from what is shown in the table.

We believe that the fixed maturity portfolio's exposure to credit risk is minimal as approximately 81.3% of the bonds we own are rated AA or better. We do not intend to change our investment policy on the quality of our fixed maturity investments. The fixed maturity portfolio is managed in a laddered-maturity style and considers business mix and liability payout patterns to ensure adequate cash flow to meet claims as they are presented. We also manage liquidity risk by maintaining sufficient cash balances, owning some agency and U.S. Treasury securities at all times, purchasing bonds of major issuers, and purchasing bonds that are part of a medium or large issue. The fixed maturity portfolio does not have any direct exposure to either exchange rate risk or commodity risk. We do not rely on the use of derivative financial instruments. To provide us greater flexibility in order to manage our market risk exposures, we categorize our fixed maturities as available-for-sale. We do not maintain a trading portfolio.

We have no mortgage backed securities in our fixed maturity portfolio which may be labeled sub-prime mortgage backed securities. We invest only in conventional mortgage backed securities issued by a federal agency or that are U.S. Government guaranteed. Specifically, approximately \$399.7 million or 21.0% of our fixed maturity available-for-sale investment portfolio as of December 31, 2012, were in either Ginnie Mae pools, which are guaranteed by the full faith and credit of the U.S. Government, or Fannie Mae or Freddie Mac pools. In 2008, both Fannie Mae and Freddie Mac received additional U.S. Government backing when they were placed into conservatorship.

Our fixed maturity investment portfolio at December 31, 2012 included obligations of states and political subdivisions with a total carrying value of \$800.3 million, with \$266.6 million of these securities, or 33.3% of our municipal securities portfolio ( Muni Portfolio ), enhanced by third party monoline insurers (a Credit Enhancement ) for the payment of principal and interest in the event of an issuer default. A Credit Enhancement is not a primary consideration to us when purchasing a municipal security, as we consider





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

the underlying credit quality of the security as the primary rating factor in our evaluation process. Of the total \$800.3 million of municipal securities in our investment portfolio at December 31, 2012, 88.8% were rated AA or better, without the benefit of a Credit Enhancement. We do not believe that a loss of a Credit Enhancement would have a material adverse impact on our results of operations, financial position or liquidity, due to the underlying strength of the issuers of the securities, as well as our ability and intent to hold the securities. In addition, as of December 31, 2012, we had no direct investment in any guarantor including any bond insurer.

The following table sets forth the credit ratings of our municipal securities, excluding Credit Enhancements, based on ratings by nationally recognized rating agencies at December 31, 2012:

Rating	Total fair	
	value	%
<i>(\$ millions)</i>		
AAA*	\$ 270.6	33.8
AA	440.3	55.0
A	82.5	10.3
Other	6.9	0.9
<b>Total</b>	<b>\$ 800.3</b>	<b>100.0</b>

\* Our AAA rating category includes securities which have been either pre-funded or escrowed to maturity.

The following table sets forth the composition of the insurers providing Credit Enhancements, along with the corresponding underlying credit rating of the issuer of the security, at December 31, 2012:

Monoline Insurer / Underlying Rating

<i>(\$ millions)</i>	Total fair value
Assured Guaranty Municipal Corp. (formerly FSA):	
AAA	\$ 44.7
AA	82.6
A	12.3
	<b>139.6</b>
AMBAC:	
AAA	25.8
AA	26.3
A	6.1
	<b>58.2</b>
FGIC:	
AAA	3.3
AA	0.3
	<b>3.6</b>

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

National Public Finance Guarantee (formerly MBIA):	
AAA	10.8
AA	48.7
A	3.3
	62.8
XLCA:	
A	2.4
<i>Total municipal securities enhanced by third party monoline insurers</i>	<b>\$ 266.6</b>

We believe our Muni Portfolio is well diversified by issuer and state. We have 14.8% invested in securities which have been either pre-refunded or escrowed to maturity bonds. Within the non pre-refunded and escrowed to maturity portfolio, no single issuer comprises more than 5.0% of the portfolio and no more than 10.0% of the portfolio is concentrated in any one state. We believe our Muni Portfolio is invested within the strongest sectors of the municipal bond market. 28.8% of our municipal bonds are general obligation bonds or other tax-backed bonds. The majority of the remaining Muni Portfolio consists of revenue bonds. Our credit research is an important part of our investment management process, and we continually monitor all holdings for any signs of deterioration. We believe that our municipal holdings will maintain their high credit quality and that the issuers will be able to make all principal and interest payments as they come due.

During 2012 and 2011, we experienced a high level of call activity with respect to both our tax exempt and taxable bonds due to the low interest rate environment. The proceeds from the call, maturity or sale of securities within our Muni Portfolio have been reinvested into both tax exempt and taxable fixed income securities with lower rates of return.

As of December 31, 2012, our large-cap equity portfolio had a beta of 1.05 using the S&P 500 Index as a benchmark. Beta estimates the degree the portfolio's price will fluctuate based on a given movement in the market index. The following table sets forth what changes might occur in the value of the large-cap equity portfolio given a change in the S&P 500 Index at December 31, 2012:

Fair value (\$ millions)	\$ 210.8	\$ 192.5	\$ 174.2	\$ 155.9	\$ 137.6
Change in S&P 500 Index	+20%	+10%	0	-10%	-20%
Value as % of original value	121%	111%	100%	90%	79%

The above analysis is limited in that it does not take into account any actions that might be taken by us in response to these changes. As a result, the actual impact of a change in equity market prices and the resulting equity values may differ significantly from what is shown in the table. By investing in mostly large-cap issues we hope to limit liquidity risk in the equity portfolio. The large-cap equity portfolio does not have any direct exposure to exchange rate risk since we do not directly hold any foreign stocks. We constantly monitor the equity portfolio holdings for any credit risk issues that may arise. We do not invest in any commodity futures or commodity oriented mutual funds.

At December 31, 2012, we have two international funds, Fund 1 and Fund 2, which are included in other invested assets available-for-sale. Fund 1 and Fund 2 had betas of 0.69 and 0.84, respectively, using the MSCI EAFE Index as a benchmark. Beta estimates the degree the portfolio's price will fluctuate based on a given movement in the index. The following tables set forth what changes might occur in the values of Funds 1 and 2 given a change in the MSCI EAFE Index at December 31, 2012:

Fund 1					
Fair value (\$ millions)	\$ 29.7	\$ 27.9	\$ 26.1	\$ 24.3	\$ 22.5
Change in MSCI EAFE Index	+20%	+10%	0	-10%	-20%
Value as % of original value	114%	107%	100%	93%	86%

Fund 2					
Fair value (\$ millions)	\$ 38.3	\$ 35.6	\$ 32.8	\$ 30.0	\$ 27.3
Change in MSCI EAFE Index	+20%	+10%	0	-10%	-20%
Value as % of original value	117%	108%	100%	92%	83%

The above analysis does not take into account any actions that might be taken by the portfolio managers in response to these changes. As a result, the actual impact of a change in international equity market prices and the resulting international equity values may differ significantly from what is shown in the tables above.

*Investment Operations Revenue*

The following table sets forth the components of net investment income for the years ended December 31, 2012, 2011 and 2010:

(\$ millions)	Year Ended December 31		
	2012	2011	2010
<b>Gross investment income:</b>			
Fixed maturities	\$ 66.9	\$ 77.0	\$ 71.7
Equity securities	4.9	4.9	5.4
Other	5.6	5.7	5.8
<b>Total gross investment income</b>	<b>77.4</b>	<b>87.6</b>	<b>82.9</b>
Less: Investment expenses	2.0	2.2	2.1
<b>Net investment income</b>	<b>\$ 75.4</b>	<b>\$ 85.4</b>	<b>\$ 80.8</b>
Average invested assets (at cost)	\$ 2,173.4	\$ 2,392.3	\$ 2,235.7
Annualized investment yield	3.5%	3.6%	3.6%
Annualized investment yield, after tax	2.7%	2.8%	2.9%
Net investment income, after tax	\$ 58.0	\$ 66.9	\$ 65.7
Effective tax rate	23.0%	21.7%	18.7%

Our investment operations revenue for the year ended December 31, 2012 was primarily impacted by the following factors.

A cash outflow of \$336.9 million related to the settlement of the 12.31.11 pool change and the initial transfer of unearned premium related to the HO QS Arrangement.

Interest earned on our fixed maturity securities declined primarily due to lower yields. As our higher yielding bonds mature or are called by the issuers, the proceeds are being reinvested at a lower interest rate.

The amortized cost value of our Treasury Inflation-Protected Securities ( TIPS ) was \$196.5 million for the year ended December 31, 2012, compared to \$231.4 million and \$187.6 million for the same 2011 and 2010 periods. The income earned on our TIPS securities, which is dependent on changes in the CPI Index, decreased by \$3.5 million when compared to the same 2011 period and increased by \$6.6 million in 2011 when compared to the same 2010 period.

During 2012 and 2011, we sold several of our equity securities for several reasons, including managing our equity holdings to be consistent with our investment policy, responding to negative outlooks, achieving our price targets, as well as to accumulate cash to be in a position to settle the transfers related to the 12.31.11 pool change with the Mutual Pooled Companies in early 2012. In 2010, to offset the decline in interest earned on our fixed maturity securities and to improve yield and cash flows, we began to hold additional high dividend paying equities.

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

The following table sets forth realized gains (losses) and the proceeds received on sale for our investment portfolio for the years ended December 31, 2012, 2011 and 2010:

(\$ millions)	2012		2011		2010	
	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale
Realized gains:						
Fixed maturities	\$ 15.7	327.8	4.4	167.6	2.4	93.6
Equity securities	19.0	97.2	41.7	152.9	15.8	65.7
Other invested assets	0.1	0.2	3.9	20.8		
<b>Total realized gains</b>	<b>34.8</b>	<b>425.2</b>	<b>50.0</b>	<b>341.3</b>	<b>18.2</b>	<b>159.3</b>
Realized losses:						
Equity securities:						
Sales	(2.6)	7.3	(5.3)	28.0	(3.1)	20.3
OTTI	(3.2)		(6.6)		(3.6)	
Fixed maturities:						
OTTI	(0.2)					
Other invested assets OTTI					(0.5)	
<b>Total realized losses</b>	<b>(6.0)</b>	<b>7.3</b>	<b>(11.9)</b>	<b>28.0</b>	<b>(7.2)</b>	<b>20.3</b>
<b>Net realized gain (loss) on investments</b>	<b>\$ 28.8</b>	<b>432.5</b>	<b>38.1</b>	<b>369.3</b>	<b>11.0</b>	<b>179.6</b>

Equity sales were executed for various reasons in 2012, 2011 and 2010, including: (i) to accumulate cash for settlement of the transfers related to the 12.31.11 pool change (ii) the achievement of our price target, (iii) in response to negative outlook announcements or changes in business conditions which in our opinion diminished the future business prospects of certain securities and (iv) in order to manage our equity holdings to be consistent with our investment policy.

When a fixed maturity security has been determined to have an other-than-temporary decline in fair value, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income (loss). See Critical Accounting Policies Investments included in this Item 7 for OTTI impairment indicators. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income (loss). We recognized OTTI on our fixed maturity portfolio during 2012 of \$0.2 million and did not recognize any impairments on our fixed maturity portfolio during 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 Critical Accounting Policies Investments included in this Item 7 for OTTI impairment indicators. This results in a charge to earnings as a realized loss, which is not reversed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income (loss).

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

(\$ millions)	Number	
	of positions	Total impairment
Equity Securities:		
Small-cap securities	38	\$ (3.2)

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

Bonds	1	(0.2)
<i>Total OTTI</i>	39	\$ (3.4)

*Gross Unrealized Investment Gains and Losses*

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

(\$ millions, except number of positions)

	Cost or amortized cost	Gross unrealized holding gains	Number of gain positions	Gross unrealized holding losses	Number of loss positions	Fair value
<b>Fixed Maturities:</b>						
U.S. treasury securities and obligations of U.S. government agencies	\$ 328.2	\$ 38.3	62	\$	2	\$ 366.5
Obligations of states and political subdivisions	750.4	50.3	297	(0.4)	12	800.3
Corporate securities	320.5	19.2	76	(1.1)	17	338.6
U.S. government agencies residential mortgage-backed securities	377.1	24.0	119	(1.4)	19	399.7
<i>Total fixed maturities</i>	<b>1,776.2</b>	<b>131.8</b>	<b>554</b>	<b>(2.9)</b>	<b>50</b>	<b>1,905.1</b>
<b>Equity Securities:</b>						
Large-cap securities	152.6	25.0	38	(3.4)	9	174.2
Small-cap securities	43.6	10.6	83			54.2
<i>Total equity securities</i>	<b>196.2</b>	<b>35.6</b>	<b>121</b>	<b>(3.4)</b>	<b>9</b>	<b>228.4</b>
Other invested assets	49.0	15.4	3			64.4
<i>Total available-for-sale investments</i>	<b>\$ 2,021.4</b>	<b>\$ 182.8</b>	<b>678</b>	<b>\$ (6.3)</b>	<b>59</b>	<b>\$ 2,197.9</b>

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

(\$ millions)	December 31, 2012	December 31, 2011	\$ Change
<b>Available-for-sale investments</b>			
<b>Unrealized gains:</b>			
Fixed maturities	\$ 128.9	117.6	11.3
Equity securities	32.2	25.6	6.6
Other invested assets	15.4	8.6	6.8
<i>Unrealized gains</i>	<b>176.5</b>	151.8	24.7
Deferred federal income tax liability (less valuation allowance)	(52.5)	(53.1)	0.6
<i>Unrealized gains, net of tax</i>	<b>\$ 124.0</b>	98.7	25.3

*Fair Value Measurements*



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

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 consolidated financial statements included in Item 8 of this Form 10-K for a presentation of our available-for-sale investments within the fair value hierarchy at December 31, 2012.

As of December 31, 2012, Level 3 assets as a percentage of total assets were 0.3%, which we have determined to be insignificant.

---

**Other Items***Income Taxes*

For the year ended December 31, 2012, federal income tax benefit was \$0.1 million compared to tax expense of \$48.6 million and less than \$0.1 million for the same 2011 and 2010 periods, respectively. The effective tax rate for 2012 of 1.0% differs from the statutory rate of 35% principally because of the valuation allowance that was established during 2011. A valuation allowance of \$103.3 million was held at December 31, 2011, with a corresponding charge to total tax expense for the year ended December 31, 2011.

See *Critical Accounting Policies* *Deferred Income Taxes* included in this Item 7. See Note 8, *Federal Income Taxes* to our consolidated financial statements included in Item 8 of this Form 10-K for a reconciliation between our actual federal income tax expense (benefit) and the amount computed at the indicated statutory rate for the years ended December 31, 2012, 2011 and 2010.

**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.

We generally manage our cash flows through current operational activity and maturing investments, without a need to liquidate any of our other investments. However, should our written premiums decline or paid losses increase significantly, or a combination thereof, our cash flows from operations could be impacted requiring us to liquidate investments at losses. This action was not necessary in 2012, 2011 or 2010, despite the increased level of catastrophe losses.

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 December 31, 2012 and 2011, we had \$59.0 million and \$356.0 million, respectively, in cash and cash equivalents, and \$2,197.9 million and \$2,159.4 million, respectively, of total available-for-sale investments. Included in our fixed maturities available-for-sale were \$10.0 million and \$9.9 million of securities on deposit with insurance regulators, as required by law, at December 31, 2012 and 2011, respectively. 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 7.

Net cash used in operating activities was \$285.6 million in 2012, compared to net cash provided by operating activities during 2011 and 2010 of \$43.0 million and \$131.4 million, respectively. Net cash from operations will vary from period to period if there are significant changes in

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

underwriting results, primarily a combination of the level of premiums written and loss and loss expenses paid, changes in cash flows from investment income or federal income tax activity. The majority of the change between 2012 and 2011 was

due to our settlement payment of \$261.4 million related to the 12.31.11 pool change and our payment of \$75.5 million related to our share of the State Auto Group's initial net unearned premium transfer under the HO QS Arrangement. The lower level of net cash provided by operating activities for the year ended December 31, 2011 compared to the same 2010 period was driven by the significant increase in the level of loss and loss expenses paid due to the record level of catastrophe losses that occurred in 2011 as compared to the same 2010 period. The 2011 and 2010 operational cash activity included cash inflows of \$69.1 million and \$3.7 million, respectively, due to pooling changes.

Net cash provided by investing activities was \$9.3 million and \$246.2 million for 2012 and 2011, respectively, compared to net cash used in investing activities of \$112.6 million in 2010. The following factors significantly contributed to the fluctuations between those years:

In early 2012 we continued to raise funds to complete the settlement of amounts owed related to the 12.31.11 pool change and the HO QS Arrangement.

In 2011, we sold equity securities and certain fixed maturity securities in order to accumulate cash to be in a position to settle the transfers related to the 12.31.11 pool change with the Mutual Pooled Companies in early 2012.

Also in 2011, we had a cash inflow of \$13.2 million, primarily related to our sale of SA National, compared to a cash outflow of \$7.5 million in 2010. The amount paid in 2010 approximated SA National's cash position on that date.

#### **Borrowing Arrangements**

##### *Credit Facility*

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

##### *Senior Notes*

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

In early 2013, State Auto P&C became a member of the Federal Home Loan Bank of Cincinnati (FHLB). We intend to refinance the Senior Notes with a secured borrowing with the FHLB.

##### *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 December 31, 2012 and 2011 were 4.51% and 4.73%, respectively.

*Notes Payable Summary*

The following table sets forth our notes payable at December 31, 2012:

(\$ millions)	Carrying	Fair	Interest
	Value	Value	Rate
Senior Notes due 2013: issued \$100.0 million, November 2003 with fixed interest	\$ 100.4	\$ 100.3	6.25%
Subordinated Debentures due 2033: issued \$15.5 million, May 2003 with variable interest adjusting quarterly	15.5	15.5	4.51%
<b>Total notes payable</b>	<b>\$ 115.9</b>	<b>\$ 115.8</b>	

Related to our notes payable, our primary market risk exposure is to the change in interest rates and our credit rating. For a discussion regarding our credit ratings see *Credit and Financial Strength Ratings* included in this Item 7. Based upon the notes payable carrying value at December 31, 2012, we had \$15.5 million notes payable with variable interest and \$100.4 million notes payable with interest fixed at 6.25%, which equated to approximately 13.3% variable interest debt and 86.7% fixed interest debt. Our decision to obtain fixed versus variable interest rate debt is influenced primarily by the following factors: (a) current market interest rates; (b) anticipated future market interest rates; (c) availability of fixed versus variable interest instruments; and (d) our currently existing notes payable fixed and variable interest rate position. See our contractual obligations table included in *Contractual Obligations* included in this Item 7.

**Reinsurance Arrangements**

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

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

*Homeowners Quota Share Reinsurance Arrangement*

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

Under the HO QS Arrangement, the State Auto Group receives a 29.0% commission on all premiums ceded to the reinsurers during the term of the agreement. Subject to the terms and conditions of the HO QS Arrangement, the State Auto Group may receive a profit commission.

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

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

Under the HO QS Arrangement, the reinsurers have agreed to accept 75% of the State Auto Group's subject homeowners net liability. The liability of the reinsurers will not exceed any of the following: \$3.0 million as to any one risk with respect to property losses; \$2.0 million as to any one insured with respect to liability losses; \$55.0 million as to all losses arising from any one loss occurrence; 50% of the ceded net earned premium for the first contract year with respect to all losses arising from all catastrophe loss occurrences commencing during the first contract year, subject to an amount not to exceed \$181.0 million for the first contract year; 40% of the ceded net earned premium for the second contract year with respect to all losses arising from all catastrophe loss occurrences commencing during the second contract year, subject to an amount not to exceed \$150.0 million for the second contract year; 30% of the ceded net earned premium for the third contract year with respect to all losses arising from all catastrophe loss

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

#### *Other Reinsurance Arrangements*

Each member of the State Auto Group is party to working reinsurance treaties for casualty, workers' compensation and property lines with several reinsurers arranged through reinsurance intermediaries. These agreements are described in more detail below. We have also secured other reinsurance to limit the net cost of large loss events for certain types of coverage. The State Auto Group also makes use of facultative reinsurance for unique risk situations. The State Auto Group also participates in state insurance pools and associations. In general, these pools and associations are state sponsored and/or operated, impose mandatory participation by insurers doing business in that state, and offer coverage for hard-to-place risks at premium rates established by the state sponsor or operator, thereby transferring risk of loss to the participating insurers in exchange for premiums which may not be commensurate with the risk assumed.

#### *Property Catastrophe*

Members of the State Auto Group maintain a property catastrophe excess of loss reinsurance agreement, covering catastrophe related events affecting at least two risks. As of June 1, 2012, this property catastrophe reinsurance agreement was revised to include property business written through our specialty insurance segment. Under this agreement, the State Auto Group retains the first \$55.0 million of catastrophe loss, each occurrence, with a 5% co-participation on the next \$245.0 million of covered loss, each occurrence. The reinsurers are responsible for 95% of the excess over \$55.0 million up to \$300.0 million of covered losses, each occurrence. Under this agreement, the State Auto Group is responsible for losses above \$300.0 million.

For property policies underwritten by our Rockhill unit, the State Auto Group also maintains a separate property catastrophe excess of loss reinsurance agreement covering catastrophe related events affecting at least two risks. Under this agreement, the State Auto Group retains the first \$15.0 million of catastrophe loss, each occurrence, and the reinsurers are responsible for 100% of the excess over \$15.0 million up to \$55.0 million of covered loss, each occurrence. The rates for this reinsurance are negotiated annually.

#### *Property Per Risk*

As of July 1, 2012, the property per risk excess of loss reinsurance agreement was revised to include the Rockhill unit's property business. This reinsurance agreement provides that the State Auto Group is responsible for the first \$1.0 million of each covered loss for business written as Rockhill unit's property business, and first \$3.0 million of each covered loss for other property business. The State Auto Group also is responsible for an additional \$2.0 million in aggregate retention per treaty year for losses exceeding \$3.0 million. The reinsurers are responsible for 100% of the excess over \$3.0 million up to \$20.0 million of covered loss. The rates for this reinsurance are negotiated annually.

For property policies underwritten by our Rockhill unit, the State Auto Group also maintains a property surplus share agreement for wind-only insurance products. This agreement provides for a proportional share of losses on all coastal wind policies written with limits greater than \$5.0 million and up to \$10.0 million of covered loss and all non coastal wind policies written with limits greater than \$10.0 million and up to \$16.0 million of covered loss. The reinsurers' limit cannot exceed more than \$5.0 million on any one risk.

#### *Casualty and Workers' Compensation*

As of July 1, 2012, the State Auto Group revised its casualty excess of loss reinsurance agreement to include coverage for umbrella liability and workers' compensation losses. Under this agreement, each company in the State Auto Group is responsible for the first \$2.0 million of workers' compensation, umbrella, auto and other liability losses. The reinsurance agreement provides coverage up to \$10.0 million. Policies underwritten by the Rockhill unit are not subject to this casualty excess of loss reinsurance agreement. For workers' compensation risks, the State Auto Group also renewed a treaty that provides \$1.0 million of coverage in excess of \$1.0 million retention, subject to an additional \$1.0 million in annual aggregate retention.

Also, certain unusual claim situations involving bodily injury liability, property damage, uninsured motorist and personal injury protection are covered by an arrangement that provides for \$30.0 million of coverage in excess of \$10.0 million retention for each loss occurrence. This reinsurance sits above the \$8.0 million excess of \$2.0 million arrangement. The rates for this reinsurance are negotiated annually. Policies underwritten by the Rockhill unit are not subject to this casualty excess of loss reinsurance agreement.

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

In addition to the workers' compensation reinsurance described above, each company in the State Auto Group is party to an agreement which provides an additional layer of reinsurance for workers' compensation losses involving multiple workers. Subject to \$10.0 million of retention, reinsurers are responsible for 100% of the excess over \$10.0 million up to \$30.0 million of covered loss. This coverage is subject to a Maximum Any One Life limitation of \$20.0 million. This limitation means that losses associated with each worker may contribute no more than \$20.0 million to covered loss under this agreement. The rates for this reinsurance are negotiated annually.



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

For liability policies written through our Rockhill unit, the State Auto Group has a consolidated casualty treaty whereby it retains the first \$1.0 million of covered loss and the reinsurers are responsible for 87% of loss in excess of \$1.0 million up to \$11.0 million. The rates for this reinsurance are negotiated annually.

As of October 1, 2011, the State Auto Group entered into a quota share reinsurance agreement for Management & Professional Liability arising out of certain classes of business underwritten in our Rockhill unit. For any subject losses, the treaty pays 40% of 100%, up to 40% of \$10.0 million, or \$4.0 million. The remaining loss amount was covered by the consolidated casualty reinsurance agreement. As of July 1, 2012, this reinsurance agreement was terminated.

### Surety

As of November 1, 2012, the State Auto Group entered into a surety excess of loss for business written by its surety underwriting unit. Reinsurers under this treaty are responsible for the ultimate net loss exceeding \$1.0 million up to a reinsurer limit of \$4.0 million. Total amounts recoverable under this treaty may not exceed \$12.0 million during the one-year term of the agreement.

### Contractual Obligations

The following table sets forth our significant contractual obligations at December 31, 2012:

<i>(\$ millions)</i>	Total	Due 1 year or less	Due 1-3 years	Due 3-5 years	Due after 5 years
Direct loss and ALAE reserves <sup>(1)</sup>	\$ 932.2	386.0	309.2	111.7	125.3
Notes payable <sup>(2)</sup> :					
Senior Notes due 2013: issued \$100.0, November 2003 with fixed interest <sup>(3)</sup>	100.0	100.0			
Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest <sup>(4)</sup> adjusting quarterly	15.5				15.5
<b>Total notes payable</b>	<b>115.5</b>	<b>100.0</b>			<b>15.5</b>
Interest payable <sup>(2)</sup> :					
Senior Notes due 2013: issued \$100.0, November 2003 with fixed interest <sup>(3)</sup>	6.3	6.3			
Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest <sup>(4)</sup> adjusting quarterly	15.8	0.7	1.5	1.5	12.1
<b>Total interest payable</b>	<b>22.1</b>	<b>7.0</b>	<b>1.5</b>	<b>1.5</b>	<b>12.1</b>
Postretirement benefits	18.3	2.0	4.0	3.8	8.5
Pension funding <sup>(5)</sup>	65.4	7.5	14.3	13.6	30.0
<b>Total</b>	<b>\$ 1,153.5</b>	<b>502.5</b>	<b>329.0</b>	<b>130.6</b>	<b>191.4</b>

<sup>(1)</sup> We derived expected payment patterns separately for the direct loss and ALAE reserves. Amounts included the STFC Pooled Companies net additional share of transactions assumed from State Auto Mutual through the Pooling Arrangement. For a reconciliation of management's best estimate, see Critical Accounting Policies - Losses and Loss Expenses Payable included in this Item 7. These patterns were applied to the December 31, 2012, loss and ALAE payable to generate estimated annual incremental loss and ALAE payments for each subsequent calendar year. These amounts are based on historical payment patterns and do not represent actual contractual obligations. The actual payment amounts and the related timing of those payments could differ significantly from these estimates.

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

- (2) For a discussion of these debt instruments, see *Liquidity and Capital Resources - Borrowing Arrangements* included in this Item 7.
- (3) The Senior Notes bear interest at a fixed rate of 6.25% per annum, which is payable each May 15 and November 15.
- (4) Interest on the subordinated debentures was calculated using an interest rate equal to the three-month LIBOR rate at December 31, 2012 of 0.3105% plus 4.20%, or 4.5105%.
- (5) These amounts are estimates of ERISA minimum funding levels based on adjustments to prior year assumptions for our defined benefit pension plan and do not represent an estimate of our expected contributions. Funding levels generally are not determined until later in the year with respect to the contribution year. See Note 9, *Pension and Postretirement Benefits Plans* to our consolidated financial statements included in Item 8 of this Form 10-K for a tabular presentation of STFC's share of expected benefit payments from the State Auto Group's defined benefit pension plan.

Lease and other purchase obligations of State Auto Mutual are allocated to us through the Pooling Arrangement.

### **Regulatory Considerations**

At December 31, 2012, 2011 and 2010, each of our insurance subsidiaries was in compliance with statutory requirements relating to capital adequacy.

The NAIC utilizes a collection of analytical tools designed to assist state insurance departments with an integrated approach to screening and analyzing the financial condition of insurance companies operating in their respective states. One such set of analytical

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

tools is 12 key financial ratios that are known in the insurance industry as the IRIS ratios. A defined range of results for each ratio has been established by the NAIC for solvency monitoring. While management utilizes each of these IRIS ratios in monitoring our insurance companies operating performance on a statutory accounting basis (each of our insurance subsidiaries operates within the defined range for the other measures), the net premiums written to surplus or leverage ratio is monitored to ensure that each of our insurance subsidiaries continue to operate within the defined range of 3.0 to 1.0. The higher the leverage ratio, the more risk a company bears in relation to statutory surplus available to absorb losses. In considering this range, management also considers the distribution of net premiums between property and liability lines of business. A company with a larger portion of net premiums from liability lines should generally maintain a lower leverage ratio.

The following table sets forth the statutory leverage ratios for our insurance subsidiaries at December 31, 2012, 2011 and 2010:

Statutory Leverage Ratios	2012	2011 <sup>(1)</sup>	2010 <sup>(1)</sup>
State Auto P&C	1.6	2.0	1.7
Milbank	2.2	2.7	1.7
SA Ohio	0.0	1.2	1.2
Weighted Average	1.7	2.1	1.7

- (1) Table excludes the one-time impact on net written premiums of \$34.1 million, \$106.8 million and \$1.4 million occurred in conjunction with the 1.1.11 pool change, the 12.31.11 pool change and 2010 pool changes, respectively.

Our insurance subsidiaries pay dividends to State Auto Financial which in turn may be used by State Auto Financial to pay dividends to shareholders or to make principal and interest payments on debt. Individual states limit the amount of dividends that our insurance subsidiaries domiciled in those states can pay without prior approval. Under current law, \$62.6 million is available in 2013 for payment as a dividend from our insurance subsidiaries to State Auto Financial, without prior approval from our respective domiciliary state insurance departments. State Auto Financial received \$20.0 million and \$56.4 million in dividends from its insurance subsidiaries in 2012 and 2010, respectively. We are required to notify the insurance subsidiaries applicable state insurance commissioner within five business days after declaration of all such dividends and at least ten days prior to payment. Additionally, the domiciliary state commissioner of each insurance subsidiary has the authority to limit a dividend when the commissioner determines, based on factors set forth in the law, that an insurer's surplus is not reasonable in relation to the insurer's outstanding liabilities and adequate to meet its financial needs. Such restrictions are not expected to limit the capacity of State Auto Financial to meet its cash obligations.

State Auto Financial's insurance subsidiaries are subject to regulation and supervision by the states in which they do business. The NAIC has developed risk-based capital requirements, which attempts to relate an individual insurance company's statutory surplus to the risk inherent in its overall operations. RBC requires the calculation of a ratio of total adjusted statutory capital to authorized control level. Insurers with a ratio below 200% are subject to different levels of regulatory intervention and action. At December 31, 2012, the ratio of total adjusted statutory capital to authorized control level of State Auto Financial's insurance subsidiaries ranged from 456.3% to 4,869.2%.

### Credit and Financial Strength Ratings

The following table sets forth our credit and insurance company financial strength ratings as of February 25, 2013:

	A.M. Best	Moody's	Standard & Poor's
State Auto Financial (credit rating)	bbb	Baa3	BB+
	stable outlook	negative outlook	negative outlook
State Auto Group (financial strength)	A	A3	BBB+
	stable outlook	negative outlook	negative outlook

We are reviewed regularly by the independent rating agencies, including those rating agencies listed in the table above. We believe that these ratings provide a meaningful way for policyholders, agents, creditors, shareholders and others to compare us to our competitors. Our ratings are influenced by many factors, including operating and financial performance, asset quality, liquidity, financial leverage, exposure to catastrophe risks and operating leverage.

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

The credit ratings set forth above relate to the Senior Notes issued by State Auto Financial and express the opinion of the rating agency as to the ability of State Auto Financial to meet its ongoing obligations under the terms of the Senior Notes. Generally, credit ratings affect the cost, type and availability of debt financing. Higher rated securities receive more favorable pricing and terms relative to lower rated securities at the time of issue.

The financial strength ratings set forth above relate to the State Auto Group and express the opinion of the rating agency as to the ability of the State Auto Group to meet its ongoing obligations to policyholders. The A.M. Best financial strength rating influences our ability to write insurance business as agents and policyholders generally prefer higher rated companies. Lower rated companies may be required to compete for agents and policyholders by offering higher commissions or lower premiums and expanded coverage, or a combination thereof.

---

**OTHER**

**Impact of Inflation**

Inflation can have a significant impact on property and casualty insurers because premium rates are established before the amount of losses and loss expenses are known. When establishing rates, we attempt to anticipate increases from inflation subject to the limitations of modeling economic variables. Even when general inflation, as measured by the Consumer Price Index, is relatively modest, as has been the case over the last several years, price inflation on the goods and services purchased by insurance companies in settling claims can steadily increase. For example, medical care costs have risen at a higher rate than general inflation over the last few years. Costs for building materials typically rise dramatically following widespread natural catastrophes, such as the industry experienced in 2008 with Hurricane Ike. We continue to adjust our pricing projections to reflect current and anticipated changes in costs in all lines of business.

We consider inflation when estimating liabilities for losses and loss expenses, particularly for claims having a long period between occurrence and final settlement. The liabilities for losses and loss expenses are management's best estimates of the ultimate net cost of underlying claims and expenses and are not discounted for the time value of money. In times of high inflation, the normally higher yields on investment income may partially offset potentially higher claims and expenses.

**New Accounting Standards**

*Adoption of Recent Accounting Pronouncements*

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

In October 2010, the FASB issued updated guidance to address diversity in practice for the accounting of costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. This guidance was effective for fiscal years beginning after December 15, 2011. The Company adopted this guidance, with retrospective application, at January 1, 2012. The cumulative effect of the retrospective adoption of this guidance reduced stockholders' equity by \$20.5 million, after-tax, at January 1, 2010. See Note 1 of our consolidated financial statements included in Item 8 of this Form 10-K.

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

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

**Item 7A. Qualitative and Quantitative Disclosures about Market Risk**

Qualitative and Quantitative Disclosures about Market Risk are included in Item 7 of this Form 10-K under Results of Operations Investment Operations Segment Market Risk.

**Item 8. Financial Statements and Supplementary Data**

Our consolidated financial statements, including the notes thereto, and the reports of Ernst & Young LLP on our consolidated financial statements and our internal controls over financial reporting are as follows:

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders of

State Auto Financial Corporation

We have audited the accompanying consolidated balance sheets of State Auto Financial Corporation and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income (loss), stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. Our audits also included the financial statement schedules listed in the Index at Item 15(a)(2). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of State Auto Financial Corporation and subsidiaries at December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for deferred acquisition costs in 2012.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), State Auto Financial Corporation and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 8, 2013, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Columbus, Ohio

March 8, 2013

---

**Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting**

The Board of Directors and Stockholders of

State Auto Financial Corporation

We have audited State Auto Financial Corporation and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). State Auto Financial Corporation's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, State Auto Financial Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of State Auto Financial Corporation and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012, and our report dated March 8, 2013, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Columbus, Ohio

March 8, 2013

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Consolidated Balance Sheets**

(in millions, except per share amounts)

December 31

	2012	2011 As adjusted (see Note 1)
<b>Assets</b>		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,776.2 and \$1,817.3, respectively)	\$ 1,905.1	1,934.9
Equity securities, available-for-sale, at fair value (cost \$196.2 and \$141.7, respectively)	228.4	167.3
Other invested assets, available-for-sale, at fair value (cost \$49.0 and \$48.6, respectively)	64.4	57.2
Other invested assets	0.5	0.5
Notes receivable from affiliate	70.0	70.0
<b>Total investments</b>	<b>2,268.4</b>	<b>2,229.9</b>
Cash and cash equivalents	59.0	356.0
Accrued investment income and other assets	31.5	30.2
Deferred policy acquisition costs	91.7	91.7
Reinsurance recoverable on losses and loss expenses payable	13.5	25.5
Prepaid reinsurance premiums	3.9	7.9
Current federal income taxes		12.3
Net deferred federal income taxes	1.0	0.5
Property and equipment, at cost (net of accumulated depreciation of \$5.6 and \$7.5, respectively)	8.8	10.4
<b>Total assets</b>	<b>\$ 2,477.8</b>	<b>2,764.4</b>
<b>Liabilities and Stockholders' Equity</b>		
Losses and loss expenses payable (affiliates \$435.1 and \$376.8, respectively)	\$ 942.2	907.1
Unearned premiums (affiliates \$81.9 and \$98.4, respectively)	481.6	470.2
Notes payable (affiliates \$15.5 and \$15.5, respectively)	115.9	116.4
Postretirement and pension benefits	113.0	112.8
Due to affiliate	8.6	349.4
Other liabilities	79.3	84.7
<b>Total liabilities</b>	<b>1,740.6</b>	<b>2,040.6</b>
<b>Stockholders' equity:</b>		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued		
Common stock, without par value. Authorized 100.0 shares; 47.3 and 47.1 shares issued, respectively, at stated value of \$2.50 per share	118.1	117.8
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	(115.8)	(115.8)
Additional paid-in capital	131.6	127.3
Accumulated other comprehensive income	84.2	63.8
Retained earnings	519.1	530.7



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

<i>Total stockholders equity</i>	<b>737.2</b>	723.8
<i>Total liabilities and stockholders equity</i>	<b>\$ 2,477.8</b>	2,764.4

See accompanying notes to consolidated financial statements.

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

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Consolidated Statements of Income**

(\$ millions, except per share amounts)

Year ended December 31

	2012	2011 As adjusted (see Note 1)	2010 As adjusted (see Note 1)
Earned premiums (ceded to affiliate \$809.2, \$803.6 and \$818.8, respectively)	\$ 1,042.1	1,428.8	1,257.2
Net investment income (affiliates \$4.9, \$4.9 and \$4.9, respectively)	75.4	85.4	80.8
Net realized gain on investments:			
Total other-than-temporary impairment losses	(3.4)	(6.6)	(4.1)
Portion of loss recognized in other comprehensive income			
Other net realized investment gains	32.4	43.6	19.0
Total net realized gain on investments	29.0	37.0	14.9
Other income (affiliates \$3.6, \$2.5 and \$2.2, respectively)	3.6	2.5	2.2
<b>Total revenues</b>	<b>1,150.1</b>	<b>1,553.7</b>	<b>1,355.1</b>
Losses and loss expenses (ceded to affiliate \$575.7, \$701.0 and \$579.1, respectively)	778.3	1,180.0	889.6
Acquisition and operating expenses	345.9	485.0	424.5
Interest expense (affiliates \$0.7, \$0.7 and \$0.7, respectively)	7.0	7.1	7.1
Postretirement benefit curtailment gain		(14.9)	
Other expenses	8.3	8.6	9.5
<b>Total expenses</b>	<b>1,139.5</b>	<b>1,665.8</b>	<b>1,330.7</b>
<b>Income (loss) before federal income taxes</b>	<b>10.6</b>	<b>(112.1)</b>	<b>24.4</b>
Federal income tax (benefit) expense:			
Current	(0.1)	(7.0)	7.7
Deferred		55.6	(7.7)
<b>Total federal income tax (benefit) expense</b>	<b>(0.1)</b>	<b>48.6</b>	
<b>Net income (loss)</b>	<b>\$ 10.7</b>	<b>(160.7)</b>	<b>24.4</b>
Earnings (loss) per common share:			
Basic	\$ 0.26	(4.00)	0.61
Diluted	\$ 0.27	(4.00)	0.62
Dividends paid per common share	\$ 0.55	0.60	0.60

See accompanying notes to consolidated financial statements.



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

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Consolidated Statements of Comprehensive Income (Loss)**

(\$ millions)

Year ended December 31

	2012	2011 As adjusted (see Note 1)	2010 As adjusted (see Note 1)
Net income (loss)	\$ 10.7	(160.7)	24.4
Other comprehensive income (loss), net of tax:			
Net unrealized holding gains on investments:			
Unrealized holding gains arising during year	53.5	80.2	34.9
Reclassification adjustments for gains realized in net income (loss)	(28.8)	(38.1)	(11.5)
Income tax benefit (expense)	0.6	(14.7)	(8.2)
<i>Total net unrealized holding gains on investments</i>	<b>25.3</b>	27.4	15.2
Amortization of gain on derivative used in cash flow hedge	(0.1)	(0.1)	(0.1)
Net unrecognized benefit plan obligations:			
Net actuarial loss arising during period	(7.4)	(69.8)	(33.9)
Negative plan amendment gain on postretirement healthcare benefit plan		93.8	
Reclassification adjustments for amortization to statements of income:			
Transition asset		(0.3)	(0.8)
Negative prior service cost	(5.2)	(19.0)	(3.0)
Net actuarial loss	7.8	7.2	6.8
Effect of December 31, 2011 pooling change		59.1	
Income tax (benefit) expense		(26.6)	10.8
<i>Total net unrecognized benefit plan obligations</i>	<b>(4.8)</b>	44.4	(20.1)
<i>Other comprehensive income (loss)</i>	<b>20.4</b>	71.7	(5.0)
<b>Comprehensive income (loss)</b>	<b>\$ 31.1</b>	(89.0)	19.4

See accompanying notes to consolidated financial statements.

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

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Stockholders Equity

(in millions)

Year ended December 31

	2012	2011 As adjusted (see Note 1)	2010 As adjusted (see Note 1)
<b>Common shares:</b>			
Balance at beginning of year	47.1	46.9	46.6
Issuance of shares	0.2	0.2	0.3
<i>Balance at end of year</i>	47.3	47.1	46.9
<b>Treasury shares:</b>			
Balance at beginning of year	(6.8)	(6.8)	(6.8)
Shares acquired on stock option exercises			
<i>Balance at end of year</i>	(6.8)	(6.8)	(6.8)
<b>Common stock:</b>			
Balance at beginning of year	\$ 117.8	117.3	116.6
Issuance of shares	0.3	0.5	0.7
<i>Balance at end of year</i>	118.1	117.8	117.3
<b>Treasury stock:</b>			
Balance at beginning of year	\$ (115.8)	(115.8)	(115.7)
Shares acquired on stock option exercises			(0.1)
<i>Balance at end of year</i>	(115.8)	(115.8)	(115.8)
<b>Additional paid-in capital:</b>			
Balance at beginning of year	\$ 127.3	122.1	115.8
Issuance of common stock	1.3	2.2	2.6
Tax benefit from stock options exercises			0.3
Stock options granted	3.0	3.0	3.4
<i>Balance at end of year</i>	131.6	127.3	122.1
<b>Accumulated other comprehensive income (loss):</b>			
Balance at beginning of year	\$ 63.8	(7.9)	(2.9)
Change in unrealized gains on investments, net of tax	25.3	27.4	15.2
Amortization of gain on derivative used in cash flow hedge	(0.1)	(0.1)	(0.1)
Change in unrecognized benefit plan obligations, net of tax and reclassification adjustment	(4.8)	44.4	(20.1)

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

<i>Balance at end of year</i>	<b>84.2</b>	63.8	(7.9)
<b>Retained earnings:</b>			
Balance at beginning of year	<b>\$ 530.7</b>	715.5	735.6
Effect of adopting deferred acquisition costs (Note 1)			(20.5)
Net income (loss)	<b>10.7</b>	(160.7)	24.4
Cash dividends paid (affiliates \$13.9, \$15.2 and \$15.2, respectively)	<b>(22.3)</b>	(24.1)	(24.0)
<i>Balance at end of year</i>	<b>519.1</b>	530.7	715.5
<b><i>Total stockholders equity at end of year</i></b>	<b>\$ 737.2</b>	723.8	831.2

See accompanying notes to consolidated financial statements.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Consolidated Statements of Cash Flows**

(\$ millions)

Year ended December 31

	2012	2011 As adjusted (see Note 1)	2010 As adjusted (see Note 1)
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ 10.7	(160.7)	24.4
Adjustments to reconcile net income to net cash (used in) provided by operating activities:			
Depreciation and amortization, net	7.1	5.3	8.8
Share-based compensation	3.5	3.2	3.7
Net realized gain on investments	(29.0)	(37.0)	(14.9)
Changes in operating assets and liabilities:			
Deferred acquisition costs (benefit)		7.9	(23.1)
Accrued investment income and other assets	(1.4)	0.8	2.3
Postretirement and pension benefits	(4.6)	(9.9)	5.6
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	16.0	(7.0)	1.5
Other liabilities and due to/from affiliates, net	(9.8)	97.6	1.2
Losses and loss expenses payable	35.1	93.0	56.8
Unearned premiums	11.4	(70.2)	67.6
Excess tax benefits on share-based awards			0.3
Federal income taxes	12.3	50.9	(6.5)
Cash used in December 31, 2011 unearned premium transfer related to the homeowners quota-share reinsurance arrangement	(75.5)		
Cash (used in) provided from pooling changes, December 31, 2011, January 1, 2011 and 2010 (Note 6a)	(261.4)	69.1	3.7
<b>Net cash (used in) provided by operating activities</b>	<b>(285.6)</b>	43.0	131.4
<b>Cash flows from investing activities:</b>			
Purchases of fixed maturities available-for-sale	(540.4)	(369.7)	(546.2)
Purchases of equity securities available-for-sale	(143.0)	(92.6)	(87.4)
Purchases of other invested assets	(1.1)	(1.2)	(21.2)
Maturities, calls and pay downs of fixed maturities available-for-sale	257.0	327.2	369.3
Sales of fixed maturities available-for-sale	332.8	167.6	93.6
Sales of equity securities available-for-sale	101.8	180.9	86.0
Sales of other invested assets available-for-sale	0.7	20.8	0.9
Sale of subsidiary		13.2	(7.5)
Net additions of property and equipment	1.5		(0.1)
<b>Net cash provided by (used in) investing activities</b>	<b>9.3</b>	246.2	(112.6)
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of common stock	1.6	2.6	3.2
Payments of dividends (affiliates \$13.9, \$15.2 and \$15.2, respectively)	(22.3)	(24.1)	(24.0)

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

<i>Net cash used in financing activities</i>	(20.7)	(21.5)	(20.8)
Net (decrease) increase in cash and cash equivalents	(297.0)	267.7	(2.0)
Cash and cash equivalents at beginning of year	356.0	88.3	90.3
<b>Cash and cash equivalents at end of year</b>	<b>\$ 59.0</b>	356.0	88.3
Supplemental disclosures:			
Interest paid (affiliates \$0.7, \$0.7 and \$0.7, respectively)	\$ 7.0	7.0	7.0
Federal income taxes (received) paid	\$ (12.4)	(2.3)	6.2

See accompanying notes to consolidated financial statements.



---

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements**

**1. Summary of Significant Accounting Policies**

**a. Principles of Consolidation**

The consolidated financial statements include State Auto Financial Corporation ( State Auto Financial ), an Ohio corporation, and the following wholly owned subsidiaries of State Auto Financial:

State Auto Property and Casualty Insurance Company ( State Auto P&C ), an Iowa corporation

Milbank Insurance Company ( Milbank ), an Iowa corporation

State Auto Insurance Company of Ohio ( SA Ohio ), an Ohio corporation

Stateco Financial Services, Inc. ( Stateco ), an Ohio corporation

The consolidated financial statements also include the operations and financial position of 518 Property Management and Leasing, LLC ( 518 PML ), an Ohio limited liability company whose members are State Auto P&C and Stateco. The consolidated financials include the assets and liabilities, as well as, the operations of Farmers Casualty Insurance Company, which was merged with State Auto P&C at the close of business December 31, 2012. The consolidated financial statements also include the operations of State Auto National Insurance Company ( SA National ), an Ohio corporation and a wholly owned subsidiary of State Auto Financial through December 31, 2010, the date SA National was sold to a third party.

State Auto Financial is a majority-owned subsidiary of State Automobile Mutual Insurance Company ( State Auto Mutual ), an Ohio corporation. State Auto Financial and its subsidiaries are referred to herein as the Company. All significant intercompany balances and transactions have been eliminated in consolidation.

On December 31, 2010, State Auto Financial sold SA National to a third party for \$14.0 million. In 2010, SA National wrote approximately \$37.0 million in direct written premium, with 80% (or approximately \$30.0 million) retained by the Company under the Pooling Arrangement (see Note 6). Included in net realized gain (loss) on investments for the year ended December 31, 2010 was a \$3.9 million net gain on the sale of SA National.

**b. Description of Business**

The Company markets its insurance products throughout the United States primarily through independent agencies, which include retail agencies and wholesale brokers. The Company's principal lines of insurance include personal and commercial automobile, homeowners, commercial multi-peril, workers' compensation, general liability and fire insurance. State Auto P&C, Milbank and SA Ohio are chartered and licensed property and casualty insurers. As such, they are subject to the regulations of the applicable Departments of Insurance of their respective states of domicile (the Departments) and the regulations of each state in which they operate. These property and casualty insurance companies undergo periodic financial examination by the Departments and insurance regulatory agencies of the states that choose to participate. A large portion of the Company's revenues are derived from a reinsurance pooling agreement with State Auto Mutual and its affiliates. The underwriting activity and geographic distribution of State Auto Mutual and its affiliates is generally the same as the underwriting activity and geographic distribution of the Company.

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

Through the employees of State Auto P&C, the Company provides management and operation services under management agreements for all of its insurance and non-insurance affiliates.

Through Stateco, the Company provides investment management services to affiliated companies.

518 PML owns and leases property to the Company's affiliates.

---

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

**c. Basis of Presentation**

The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ( GAAP ), which vary in certain respects from statutory accounting practices ( SAP ) followed by State Auto P&C, Milbank and SA Ohio that are prescribed or permitted by the Departments.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, revenues and expenses for the periods then ended, and the accompanying notes to the financial statements. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of losses and loss expenses payable and the realization of deferred tax assets. In connection with the determination of losses and loss expenses payable, management uses historical data, current business conditions and assumptions about future conditions to formulate estimates of the ultimate cost to settle claims. Deferred tax assets are evaluated periodically by management to determine if they are realizable, requiring management to make certain judgments and assumptions. In evaluating the ability to recover deferred tax assets, management considers all available evidence, 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. 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 other comprehensive income. These estimates by their nature are subject to uncertainties for various reasons.

**d. Investments**

Investments in fixed maturities, equity securities and certain other invested assets are classified as available-for-sale and are carried at fair value. The unrealized holding gains and losses, net of applicable deferred 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 (loss). Realized gains and losses on the sales of investments are computed using the first-in, first-out method.

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 other comprehensive income (loss). Future increases or decreases in fair value, if not other-than-temporary, are included in 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 other comprehensive income (loss).



## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued****e. Cash Equivalents**

The Company considers all liquid debt instruments with a maturity of three months or less to be cash equivalents. The carrying amounts reported approximate their fair value.

**f. Deferred Acquisition Costs**

Acquisition costs, consisting of commissions, premium taxes and certain underwriting expenses related to the successful acquisition or renewing of property and casualty business, are deferred and amortized over the same period in which the related premiums are earned. The method followed for computing the acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premium to be earned, losses and loss expenses expected to be incurred, and certain other costs expected to be incurred as premium is earned. Future changes in estimates, the most significant of which is expected losses and loss adjustment expenses, that indicate a reduction in expected future profitability may result in unrecoverable deferred acquisition costs. See 1.k New Accounting Standards below.

The following table sets forth net deferred acquisition costs for the years ended December 31, 2012, 2011 and 2010:

<i>(\$ millions)</i>	<b>2012</b>	2011 As adjusted	2010 As adjusted
<i>Balance, beginning of year</i>	<b>\$ 91.7</b>	118.5	95.6
Effect of January 1, 2011 and 2010 pooling changes		8.3	(0.2)
Acquisition costs deferred	<b>213.1</b>	266.6	236.9
Acquisition costs amortized to expense	<b>(213.1)</b>	(274.4)	(213.8)
Effect of December 31, 2011 pooling change		(27.3)	
<i>Balance, end of year</i>	<b>\$ 91.7</b>	91.7	118.5

**g. Federal Income Taxes**

The Company files a consolidated federal income tax return. Pursuant to a written tax sharing agreement, each entity within the consolidated group pays or receives its share of federal income taxes based on separate return calculations.

The Company recognizes deferred income tax assets and liabilities for the expected future tax effects attributable to temporary differences between the financial statement and tax return bases of assets and liabilities, based on enacted tax rates and other provisions of the tax law. The effect of a change in tax laws or rates on deferred tax assets and liabilities is recognized in income in the period in which such change is enacted. Deferred tax assets and liabilities include provisions for unrealized investment gains and losses as well as the net funded status of pension and other postretirement benefit obligations with the changes for each period included in the respective components of other comprehensive income (loss). Deferred tax assets are reduced by a valuation allowance if it is more likely than not that all or some portion of the deferred tax assets will not be realized.

Interest and penalties related to uncertain tax positions are recorded in the balance sheet as other liabilities, and recognized in the income statement as other expenses.

**h. Losses and Loss Expenses Payable**

Losses and loss expenses payable are based on formula and case-basis estimates for reported claims and on estimates, based on experience and perceived trends, for unreported claims and loss expenses. The liability for unpaid losses and loss expenses, net of estimated salvage and subrogation recoverable of \$25.7 million and \$25.5 million at December 31, 2012 and 2011, respectively, has been established to cover the estimated ultimate cost to settle insured losses. The amounts are based on estimates of future rates of inflation and other factors, and accordingly, there can be no assurance that the ultimate liability will not vary materially from such estimates. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in current operations (see Note 4). Anticipated salvage and subrogation is estimated using historical experience. As such, losses and loss expenses payable represent management's best estimate of the ultimate liability related to reported and unreported claims.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

**i. Premiums**

Premiums are recognized as earned prorata over the policy period. Unearned premiums represent the portion of premiums written relative to the unexpired terms of coverage.

**j. Comprehensive Income (Loss)**

Comprehensive income (loss) is defined as all changes in an enterprise's equity during a period other than those resulting from investments by owners and distributions to owners. Comprehensive income (loss) includes net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes all other non-owner related changes to equity and includes net unrealized gains and losses on available-for-sale investments, derivative instruments and unrecognized benefit plan obligations, adjusted for deferred federal income taxes.

**k. New Accounting Standards**

*Adoption of Recent Accounting Pronouncements*

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

In October 2010, the Financial Accounting Standards Board ( 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 Company adopted this guidance, with retrospective application, at January 1, 2012. The cumulative effect of this retrospective adoption reduced stockholders' equity by \$20.5 million, after-tax, at January 1, 2010. Previously reported financial information has been revised to reflect the effect of the Company's adoption of this accounting standard.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

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

(\$ in millions)

	As Previously Reported	Effect of Change	As Adjusted
<b>December 31, 2011:</b>			
Deferred policy acquisition costs	\$ 118.1	\$ (26.4)	\$ 91.7
Other liabilities	76.6	8.1	84.7
Net deferred federal income taxes	0.5		0.5
Retained earnings	565.2	(34.5)	530.7
Stockholders' equity	758.3	(34.5)	723.8
<b>December 31, 2010:</b>			
Deferred policy acquisition costs	\$ 150.2	\$ (31.7)	\$ 118.5
Net deferred federal income taxes	(86.3)	(11.1)	(97.4)
Retained earnings	736.1	(20.6)	715.5
Stockholders' equity	851.8	(20.6)	831.2
<b>December 31, 2009:</b>			
Retained earnings	\$ 735.6	\$ (20.5)	\$ 715.1
Stockholders' equity	849.4	(20.5)	828.9

This adoption did not have any impact on cash flows from operating activities on the Company's consolidated statements of cash flows.



## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The effect of adoption of this new guidance on the consolidated statements of income and comprehensive income (loss) for the years ended December 31, 2011 and 2010 was as follows:

(\$ in millions, except per share amounts)

	For the Year Ended December 31, 2011		
	As Previously Reported	Effect of Change	As Adjusted
Acquisition and operating expenses	\$ 482.2	\$ 2.8	\$ 485.0
Income tax expense	37.5	11.1	48.6
Net loss	(146.8)	(13.9)	(160.7)
Comprehensive loss	(75.1)	(13.9)	(89.0)
Loss per share:			
Basic	\$ (3.65)	\$ (0.35)	\$ (4.00)
Diluted	\$ (3.65)	\$ (0.35)	\$ (4.00)

(\$ in millions, except per share amounts)

	For the Year Ended December 31, 2010		
	As Previously Reported	Effect of Change	As Adjusted
Acquisition and operating expenses	\$ 424.4	\$ 0.1	\$ 424.5
Income tax expense			
Net income	24.5	(0.1)	24.4
Comprehensive income	19.5	(0.1)	19.4
Earnings per share:			
Basic	\$ 0.61	\$	\$ 0.61
Diluted	\$ 0.62	\$	\$ 0.62

*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. 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 Company adopted this guidance at January 1, 2012 and it did not have a material impact on the consolidated financial statements.

*Pending Adoption of Accounting Pronouncements*

*Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*

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

The amendments in this guidance result in additional disclosure requirements under GAAP and do not change the current requirements for reporting net income or other comprehensive income in financial statements. The new guidance requires an entity to present, either in a single note, or, parenthetically on the face of the statement where net income is presented, the effects of significant amounts reclassified from each component of accumulated other comprehensive income by the respective line items of net income,

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Notes to Consolidated Financial Statements, Continued

only, if the amount reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period. If a component is not required to be reclassified to net income in its entirety, the entity would, instead, cross-reference it to the related disclosure required under GAAP. This guidance is effective prospectively for fiscal years and interim periods beginning after December 15, 2012, early adoption is permitted. The Company adopted this guidance at January 1, 2013, and it did not have a material impact on the consolidated financial statements.

## 2. Investments

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

(\$ millions)

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
<b>At December 31, 2012:</b>				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 328.2	38.3		366.5
Obligations of states and political subdivisions	750.4	50.3	(0.4)	800.3
Corporate securities	320.5	19.2	(1.1)	338.6
U.S. government agencies residential mortgage-backed securities	377.1	24.0	(1.4)	399.7
<i>Total fixed maturities</i>	<b>1,776.2</b>	<b>131.8</b>	<b>(2.9)</b>	<b>1,905.1</b>
Equity securities:				
Large-cap securities	152.6	25.0	(3.4)	174.2
Small-cap securities	43.6	10.6		54.2
<i>Total equity securities</i>	<b>196.2</b>	<b>35.6</b>	<b>(3.4)</b>	<b>228.4</b>
Other invested assets	49.0	15.4		64.4
<i>Total available-for-sale securities</i>	<b>\$ 2,021.4</b>	<b>182.8</b>	<b>(6.3)</b>	<b>2,197.9</b>

(\$ millions)

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
At December 31, 2011:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 433.8	35.0	(0.1)	468.7

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

Obligations of states and political subdivisions	761.3	50.0	(0.1)	811.2
Corporate securities	231.4	13.7	(0.3)	244.8
U.S. government agencies residential mortgage-backed securities	390.8	20.3	(0.9)	410.2
<i>Total fixed maturities</i>	1,817.3	119.0	(1.4)	1,934.9
Equity securities:				
Large-cap securities	106.4	18.9	(3.2)	122.1
Small-cap securities	35.3	9.9		45.2
<i>Total equity securities</i>	141.7	28.8	(3.2)	167.3
Other invested assets	48.6	8.6		57.2
<i>Total available-for-sale securities</i>	\$ 2,007.6	156.4	(4.6)	2,159.4

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

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

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 December 31, 2012 and 2011:

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
<b>At December 31, 2012:</b>									
<b>Fixed maturities:</b>									
U.S. treasury securities and obligations of U.S. government agencies	\$ 7.0	\$	2	\$	\$		\$ 7.0	\$	2
Obligations of states and political subdivisions	47.4	(0.4)	12				47.4	(0.4)	12
Corporate securities	80.4	(1.1)	17				80.4	(1.1)	17
U.S. government agencies residential mortgage-backed securities	23.3	(0.3)	6	34.8	(1.1)	13	58.1	(1.4)	19
<i>Total fixed maturities</i>	<b>158.1</b>	<b>(1.8)</b>	<b>37</b>	<b>34.8</b>	<b>(1.1)</b>	<b>13</b>	<b>192.9</b>	<b>(2.9)</b>	<b>50</b>
Large-cap equity securities :	23.7	(2.1)	4	8.9	(1.3)	5	32.6	(3.4)	9
<i>Total temporarily impaired securities</i>	<b>\$ 181.8</b>	<b>\$ (3.9)</b>	<b>41</b>	<b>\$ 43.7</b>	<b>\$ (2.4)</b>	<b>18</b>	<b>\$ 225.5</b>	<b>\$ (6.3)</b>	<b>59</b>

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
<b>At December 31, 2011:</b>									
<b>Fixed maturities:</b>									
U.S. treasury securities and obligations of U.S. government agencies	\$ 5.0	\$	1	\$ 9.0	\$ (0.1)	3	\$ 14.0	\$ (0.1)	4
Obligations of states and political subdivisions	8.9	(0.1)	4	2.1		1	11.0	(0.1)	5
Corporate securities	23.0	(0.3)	9				23.0	(0.3)	9
U.S. government agencies residential mortgage-backed securities	18.3	(0.1)	4	35.3	(0.8)	13	53.6	(0.9)	17
<i>Total fixed maturities</i>	<b>55.2</b>	<b>(0.5)</b>	<b>18</b>	<b>46.4</b>	<b>(0.9)</b>	<b>17</b>	<b>101.6</b>	<b>(1.4)</b>	<b>35</b>

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

Large-cap equity securities	19.3	(3.0)	9	2.7	(0.2)	1	22.0	(3.2)	10
<i>Total temporarily impaired securities</i>	\$ 74.5	\$ (3.5)	27	\$ 49.1	\$ (1.1)	18	\$ 123.6	\$ (4.6)	45

90

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The following table sets forth the realized losses related to other-than-temporary impairments on the Company's investment portfolio recognized for the years ended December 31, 2012, 2011 and 2010:

<i>(\$ millions)</i>	<b>2012</b>	2011	2010
Equity securities:			
Large-cap securities	\$	(1.0)	(0.3)
Small-cap securities	<b>(3.2)</b>	(5.6)	(3.3)
Fixed maturities	<b>(0.2)</b>		
Other invested assets			(0.5)
<i>Total other-than-temporary impairments</i>	<b>\$ (3.4)</b>	(6.6)	(4.1)

The Company reviewed its investments at December 31, 2012, and determined no additional other-than-temporary impairment exists in the gross unrealized holding losses.

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

<i>(\$ millions)</i>	Amortized cost	Fair value
Due in 1 year or less	\$ 47.3	47.9
Due after 1 year through 5 years	286.8	306.9
Due after 5 years through 10 years	463.4	502.9
Due after 10 years	601.6	647.7
U.S. government agencies residential mortgage-backed securities	377.1	399.7
<i>Total</i>	<b>\$ 1,776.2</b>	<b>1,905.1</b>

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

Fixed maturities with fair values of approximately \$10.0 million and \$9.9 million were on deposit with insurance regulators as required by law at December 31, 2012 and 2011, respectively.

The following table sets forth the components of net investment income for the years ended December 31, 2012, 2011 and 2010:

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

<i>(\$ millions)</i>	<b>2012</b>	2011	2010
Fixed maturities	<b>\$ 66.9</b>	77.0	71.7
Equity securities	<b>4.9</b>	4.9	5.4
Cash and cash equivalents, and other	<b>5.6</b>	5.7	5.8
<i>Investment income</i>	<b>77.4</b>	87.6	82.9
Investment expenses	<b>2.0</b>	2.2	2.1
<i>Net investment income</i>	<b>\$ 75.4</b>	85.4	80.8

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

Proceeds on sales of available-for-sale securities in 2012, 2011 and 2010 were \$435.3 million, \$369.3 million and \$180.5 million, respectively.



## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the years ended December 31, 2012, 2011 and 2010:

<i>(\$ millions)</i>	<b>2012</b>	2011	2010
<b>Realized gains:</b>			
Fixed maturities	<b>\$ 15.7</b>	4.4	2.4
Equity securities	<b>19.0</b>	41.7	15.8
Other invested assets	<b>0.1</b>	3.9	
<i>Total realized gains</i>	<b>34.8</b>	50.0	18.2
<b>Realized losses:</b>			
Equity securities:			
Sales	<b>(2.6)</b>	(5.3)	(3.1)
OTTI	<b>(3.2)</b>	(6.6)	(3.6)
Fixed maturities OTTI	<b>(0.2)</b>		
Other invested assets OTTI			(0.5)
<i>Total realized losses</i>	<b>(6.0)</b>	(11.9)	(7.2)
<i>Net realized gain (loss) on investments</i>	<b>\$ 28.8</b>	38.1	11.0
<b>Change in unrealized holding gains (losses), net of tax:</b>			
Fixed maturities	<b>\$ 11.3</b>	79.2	(5.3)
Equity securities	<b>6.6</b>	(30.4)	21.6
Other invested assets	<b>6.8</b>	(6.7)	7.1
Deferred federal income liability thereon	<b>(8.6)</b>	(14.7)	(8.2)
Valuation allowance	<b>9.2</b>		
<i>Change in net unrealized holding gains, net of tax</i>	<b>\$ 25.3</b>	27.4	15.2

There was a deferred federal income tax liability on the net unrealized holding gains at December 31, 2012 and 2011 of \$52.5 million, net of a valuation allowance of \$9.2 million, and \$53.1 million, respectively.

**3. Fair Value of Financial Instruments**

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

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

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

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

The Company utilizes one nationally recognized pricing service to estimate the majority of its available-for-sale investment portfolio's fair value. The Company obtains one price per security. The Company's processes and control procedures are designed to ensure the price is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company obtains 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 the valuations received to other fair value pricing from other independent pricing sources. At December 31, 2012 and 2011, the Company did not adjust any of the prices received from the pricing service.

---

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

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

The following sections describe the valuation methods used by the Company for each type of financial instrument carried at fair value.

*Fixed Maturities*

The fair value estimate of the Company's fixed maturity investments are determined by evaluations that are based on observable market information rather than market quotes. Inputs to the evaluations include, but are not limited to, market prices from recently completed transactions and transactions of comparable securities, interest rate yield curves, credit spreads, and other market-observable information. The fixed maturity portfolio pricing obtained from the pricing service is reviewed for reasonableness. Regularly, samples of security prices are referred back to the pricing service for more detailed explanation as to how the pricing service arrived at that particular price. The explanations are reviewed for reasonableness by the portfolio manager or investment officer. Additionally, the prices and assumptions are verified against an alternative pricing source for reasonableness and accuracy. Any discrepancies with the pricing are returned to the pricing service for further explanation and if necessary, adjustments are made. To date, the Company has not identified any significant discrepancies in the pricing provided by its third party pricing service. Investments valued using these inputs include U.S. treasury securities and obligations of U.S. government agencies, obligations of states and political subdivisions, corporate securities (except for two securities 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 estimates the fair values of two fixed maturity corporate securities using the present value of the future cash flows and broker quotes. Due to the limited amount of observable market information for both of these securities, the Company includes the fair value estimates 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 \$59.0 million and \$52.6 million at December 31, 2012 and 2011, respectively, which was determined using each fund's net asset value. The Company employs procedures to assess the reasonableness of the fair value of the funds including obtaining and reviewing each fund's audited financial statements. There are no unfunded commitments related to the funds. The Company may not sell its investment in the funds; however, the Company may redeem all or a portion of its investment in the funds at net asset value per share with the appropriate prior written notice. The funds are disclosed in Level 2 within the hierarchy due to the Company's ability to redeem its investment in the funds at net asset value per share at the measurement date.

The remainder of the Company's other invested assets consist 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.

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

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

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

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>At December 31, 2012:</b>				
<b>Fixed maturities:</b>				
U.S. treasury securities and obligations of U.S. government agencies	\$ 366.5		366.5	
Obligations of states and political subdivisions	800.3		800.3	
Corporate securities	338.6		330.1	8.5
U.S. government agencies residential mortgage-backed securities	399.7		399.7	
<i>Total fixed maturities</i>	<b>1,905.1</b>		<b>1,896.6</b>	<b>8.5</b>
<b>Equity securities:</b>				
Large-cap securities	174.2	174.2		
Small-cap securities	54.2	54.2		
<i>Total equity securities</i>	<b>228.4</b>	<b>228.4</b>		
Other invested assets	64.4	5.4	59.0	
<i>Total available-for-sale investments</i>	<b>\$ 2,197.9</b>	<b>233.8</b>	<b>1,955.6</b>	<b>8.5</b>

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>At December 31, 2011:</b>				
<b>Fixed maturities:</b>				
U.S. treasury securities and obligations of U.S. government agencies	\$ 468.7		468.7	
Obligations of states and political subdivisions	811.2		811.2	
Corporate securities	244.8		241.9	2.9
U.S. government agencies residential mortgage-backed securities	410.2		410.2	
<i>Total fixed maturities</i>	<b>1,934.9</b>		<b>1,932.0</b>	<b>2.9</b>

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

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

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

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 2012 and 2011, separately for each major category of assets:

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2012	\$ 2.9
Total realized gains (losses) included in earnings	(0.2)
Total unrealized gains (losses) included in other comprehensive income	
Purchases	5.8
Sales	
Transfers into Level 3	
Transfers out of Level 3	
Balance at December 31, 2012	\$ 8.5

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

**Financial Instruments Disclosed, But Not Carried, At Fair Value***Notes Receivable from Affiliates*

In May 2009, the Company entered into two separate credit agreements with State Auto Mutual pursuant to which it loaned State Auto Mutual a total of \$70.0 million. The Company estimates the fair value of the notes receivable from affiliate using market quotations for U.S. treasury securities with similar maturity dates and applies an appropriate credit spread. Consequently this has been placed in Level 2 of the fair value hierarchy.

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

*(\$ millions, except interest rates)*

	December 31, 2012			December 31, 2011		
	Carrying	Fair	Interest	Carrying	Fair	Interest
	value	value	rate	value	value	rate
Notes receivable from affiliate	\$ 70.0	\$ 78.3	7.00%	\$ 70.0	\$ 77.5	7.00%



STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

Notes Payable

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

(\$ millions, except interest rates)	December 31, 2012			December 31, 2011		
	Carrying value	Fair Value	Interest rate	Carrying value	Fair value	Interest rate
Senior Notes due 2013: issued \$100.0, November 2003 with fixed interest	\$ 100.4	\$ 100.3	6.25%	\$ 100.9	\$ 100.3	6.25%
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.5	15.5	4.51	15.5	15.5	4.73
<b>Total notes payable</b>	<b>\$ 115.9</b>	<b>\$ 115.8</b>		<b>\$ 116.4</b>	<b>\$ 115.8</b>	

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

(\$ millions)	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>At December 31, 2012:</b>				
<b>Assets:</b>				
Notes receivable from affiliate	\$ 78.3		78.3	
<b>Liabilities:</b>				
Senior Notes	100.3		100.3	
Affiliate Subordinated Debentures	15.5			15.5
<b>Total liabilities</b>	<b>\$ 115.8</b>		<b>100.3</b>	<b>15.5</b>

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Notes to Consolidated Financial Statements, Continued

## 4. Losses and Loss Expenses Payable

The following table sets forth the activity in the liability for losses and loss expenses for the years ended December 31, 2012, 2011 and 2010:

<i>(\$ millions)</i>	2012	2011	2010
Losses and loss expenses payable, at beginning of year	\$ 907.1	893.0	840.2
Less: reinsurance recoverable on losses and loss expenses payable	25.5	18.8	20.8
<i>Net balance at beginning of year</i>	<b>881.6</b>	874.2	819.4
Impact of pooling changes, January 1, 2010 and 2011 (Note 6a)		124.1	(4.0)
Incurred related to:			
Current year	795.2	1,213.3	954.2
Prior years	(16.9)	(33.3)	(64.6)
<i>Total incurred</i>	<b>778.3</b>	1,180.0	889.6
Paid related to:			
Current year	397.2	724.2	543.9
Prior years	334.0	369.1	286.9
<i>Total paid</i>	<b>731.2</b>	1,093.3	830.8
Impact of pooling change, December 31, 2011 (Note 6a)		(203.4)	
<i>Net balance at end of year</i>	<b>928.7</b>	881.6	874.2
Plus: reinsurance recoverable on losses and loss expenses payable	13.5	25.5	18.8
<i>Losses and loss expenses payable, at end of year (affiliates \$435.1, \$376.8 and \$375.8, respectively)</i>	<b>\$ 942.2</b>	907.1	893.0

The Company recorded favorable development related to prior years loss and loss expense reserves in 2012, 2011 and 2010 of \$16.9 million, \$33.3 million and \$64.6 million, respectively. Favorable development of unallocated loss adjustment expenses contributed approximately \$6.3 million of the 2012 development, while \$10.4 million was attributable to favorable development on catastrophe reserves from accident year 2011. The personal and business insurance segments non-catastrophe loss and ALAE reserves accounted for \$28.0 million of favorable development related to the latest three accident years, primarily in the personal auto liability, other & product liability, and fire & allied lines with \$10.5 million, \$9.4 million and \$5.1 million of favorable development, respectively. The favorable development in these lines was driven by emergence of lower than anticipated claim severity. The specialty insurance segment non-catastrophe loss and ALAE reserves accounted for \$27.8 million of adverse development related to the latest two accident years, which was driven by RED reserve strengthening.

Favorable development on prior years loss adjustment expense reserves contributed approximately \$7.6 million of the 2011 development, while \$4.3 million was attributable to favorable development on catastrophe reserves. The personal and business insurance segments non-catastrophe loss and ALAE reserves accounted for \$28.1 million of favorable development in 2011, primarily in the homeowners, commercial multi-peril

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

and fire & allied lines with \$14.2 million, \$6.1 million and \$4.9 million of favorable development, respectively. The favorable development in these lines was driven by emergence of lower than anticipated claim severity, primarily from accident years 2010 and 2009 as well as, to a lesser extent, the past five accident years in the commercial multi-peril line of business. The specialty insurance segment non-catastrophe loss and ALAE reserves accounted for \$6.7 million of adverse development in 2011, which was driven by greater than anticipated large losses in the commercial auto line of business and reserve increases on certain life time disability claims in the workers' compensation line of business.

---

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

Favorable prior years development of loss adjustment expenses contributed approximately \$12.7 million of the 2010 development. Of the remaining favorable development in 2010, \$10.7 million, \$10.4 million and \$9.0 million was attributable to auto liability, both personal and commercial, homeowners and fire & allied lines, respectively. The favorable development in these lines was driven by emergence of lower than anticipated claim severity, as well as lower than anticipated claim frequency for fire & allied lines. Much of the favorable development was attributable to the 2009 and, to a lesser extent, 2008 accident years.

**5. Reinsurance**

In the ordinary course of business, the Company assumes and cedes reinsurance with other insurers and reinsurers and is a member in various pools and associations. See Note 6a for discussion of reinsurance with affiliates. The voluntary arrangements provide greater diversification of business and limit the maximum net loss potential arising from large risks and catastrophes. Most of the ceded reinsurance is effected under reinsurance contracts known as treaties; the remainder is by negotiation on individual risks. Although the ceding of reinsurance does not discharge the original insurer from its primary liability to its policyholder, the insurance company that assumes the coverage assumes the related liability.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured business. The recoverability of these assets depends on the reinsurers' ability to perform under the reinsurance agreements. The Company evaluates and monitors the financial condition and concentrations of credit risk associated with its reinsurers under voluntary reinsurance arrangements to minimize its exposure to significant losses from reinsurer insolvencies. The Company has reported ceded losses and loss expenses payable and prepaid reinsurance premiums with other insurers and reinsurers as assets. All reinsurance contracts provide for indemnification against loss or liability relating to insurance risk and have been accounted for as reinsurance.

On December 31, 2011, the State Auto Group entered into the Homeowners Quota Share Arrangement, which is a three-year quota share agreement covering its homeowners book of business. Under this arrangement, the State Auto Group cedes to reinsurers 75% of its homeowners business under policies in force at the effective date and new and renewal policies thereafter issued during the term of the agreement. The arrangement remains in place until December 31, 2014. A reinsurer may terminate its participation in the arrangement upon the occurrence of certain events, including, without limitation, the following: the policyholders' surplus of the State Auto Group has been reduced by more than 25% from the amount of its surplus as of September 30, 2011; or the State Auto Group has been assigned an A.M. Best's rating below A-. As of December 31, 2012 the State Auto Group was in compliance with the terms of the arrangement. Under the arrangement, the State Auto Group will receive a 29.0% commission on all premiums ceded to the reinsurers during the term of the agreement. Subject to the terms and conditions of the arrangement, the State Auto Group may receive a profit commission. On December 31, 2011 the Company transferred \$106.3 million of unearned premium related to this arrangement. The amount of ceding commission is limited to the amount of deferred acquisition costs that would have been deferred if not for entering in the arrangement. The Company has recorded \$8.4 million and \$9.4 million of excess ceding commission as a deferred liability on the consolidated balance sheet at December 31, 2012 and 2011, respectively.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Notes to Consolidated Financial Statements, Continued

The following table sets forth the effect of the Company's external reinsurance on its balance sheets at December 31, 2012 and 2011, prior to the reinsurance transaction with State Auto Mutual under the Pooling Arrangement, as discussed in Note 6a:

(\$ millions)	December 31	
	2012	2011
<b>Losses and loss expenses payable:</b>		
Direct	\$ 499.4	517.7
Assumed	7.7	12.6
Ceded	(13.5)	(25.5)
<i>Net losses and loss expenses payable</i>	<b>\$ 493.6</b>	504.8
<b>Unearned premiums:</b>		
Direct	\$ 398.7	370.7
Assumed	1.0	1.1
Ceded	(3.9)	(7.9)
<i>Net unearned premiums</i>	<b>\$ 395.8</b>	363.9

The following table sets forth the effect of the Company's external reinsurance on its income statements for the years ended December 31, 2012, 2011 and 2010, prior to the reinsurance transaction with State Auto Mutual under the Pooling Arrangement, as discussed in Note 6a:

(\$ millions)	Year ended December 31		
	2012	2011	2010
<b>Written premiums:</b>			
Direct	\$ 860.1	814.4	852.8
Assumed	4.0	8.7	3.4
Ceded	(24.3)	(26.9)	(27.3)
<i>Net written premiums</i>	<b>\$ 839.8</b>	796.2	828.9
<b>Earned premiums:</b>			
Direct	\$ 833.3	812.1	842.1
Assumed	4.1	18.2	3.5
Ceded	(28.2)	(26.7)	(26.8)
<i>Net earned premiums</i>	<b>\$ 809.2</b>	803.6	818.8

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

Losses and loss expenses incurred:			
Direct	\$ 578.5	716.2	589.2
Assumed	3.6	12.6	2.4
Ceded	(6.4)	(25.8)	(6.1)
<i>Net losses and loss expenses incurred</i>	<b>\$ 575.7</b>	703.0	585.5

**6. Transactions with Affiliates**

**a. Reinsurance**

The insurance subsidiaries of State Auto Financial participate in a quota share reinsurance pooling arrangement ( the Pooling Arrangement ) with State Auto Mutual and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin ( SA Wisconsin ), Meridian Citizens Mutual Insurance Company ( Meridian Citizens Mutual ), Meridian Security Insurance Company ( Meridian Security ) which includes State Auto Florida Insurance Company and Beacon National Insurance Company as these

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

companies were merged with Meridian Security at the close of business on December 31, 2012, Patrons Mutual Insurance Company of Connecticut ( Patrons Mutual ) and Litchfield Mutual Fire Insurance Company ( Litchfield ). State Auto P&C, Milbank and SA Ohio are referred to as the STFC Pooled Companies, and State Auto Mutual, SA Wisconsin, Meridian Citizens Mutual, Meridian Security, Patrons Mutual and Litchfield are referred to as the Mutual Pooled Companies. The STFC Pooled Companies, the Mutual Pooled Companies, including the Rockhill Insurers (defined below), are collectively referred to as the State Auto Group.

As of January 1, 2011, the Pooling Arrangement was amended to add Rockhill Insurance Company ( Rockhill ), Plaza Insurance Company ( Plaza ), American Compensation Insurance Company ( American Compensation ) and Bloomington Compensation Insurance Company ( Bloomington Compensation ) to the pool. Rockhill, Plaza, American Compensation and Bloomington Compensation are referred to as the Rockhill Insurers. In conjunction with this amendment, 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 amendment:

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

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

(\$ millions)	(Decrease)/Increase
Losses and loss expenses payable	\$ (203.4)
Unearned premiums	(106.8)
Pension and postretirement liabilities	(52.3)
Other liabilities	22.1
Accumulated other comprehensive income	59.1
Less:	
Deferred acquisition costs	(27.3)
Other assets	7.4
<i>Net cash paid</i>	<i>\$ (261.4)</i>





STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

As of January 1, 2010, the Pooling Arrangement was amended to add SA National to the pool and to include voluntary assumed reinsurance from third parties unaffiliated with the pool participants that was assumed on or after January 1, 2010. In conjunction with this amendment, the STFC Pooled Companies received \$3.7 million in cash for net insurance assets transferred on January 1, 2010. The following table sets forth the impact on the Company's balance sheet at January 1, 2010, relating to this amendment:

<i>(\$ millions)</i>	(Decrease)/Increase
Losses and loss expenses payable	\$ (4.0)
Unearned premiums	(1.4)
Other liabilities	(0.6)
Less:	
Deferred acquisition costs	(0.2)
Other assets	(9.5)
<i>Net cash received</i>	\$ 3.7

In general, under the Pooling Arrangement, the STFC Pooled Companies and the Mutual Pooled Companies other than State Auto Mutual cede to State Auto Mutual all of their insurance business and assume from State Auto Mutual an amount equal to their respective participation percentages in the Pooling Arrangement. All premiums, losses and loss expenses and underwriting expenses are allocated among the participants on the basis of each Company's participation percentage in the Pooling Arrangement. The Pooling Arrangement provides indemnification against loss or liability relating to insurance risk and has been accounted for as reinsurance.

The Pooling Arrangement does not relieve each individual pooled subsidiary of its primary liability as the originating insurer; consequently, there is a concentration of credit risk arising from business ceded to State Auto Mutual. As the Pooling Arrangement provides for the right of offset, the Company has reported losses and loss expenses payable and prepaid reinsurance premiums to State Auto Mutual as assets only in situations when net amounts ceded to State Auto Mutual exceed net amounts assumed. All parties that participate in the Pooling Arrangement have an A.M. Best rating of A (Excellent).

The following table sets forth the reinsurance transactions on the Company's balance sheets for the Pooling Arrangement between the STFC Pooled Companies and State Auto Mutual at December 31, 2012 and 2011:

<i>(\$ millions)</i>	December 31	
	2012	2011
Losses and loss expenses payable:		
Ceded	\$ (493.6)	(504.8)
Assumed	928.7	881.6
<i>Net assumed</i>	\$ 435.1	376.8
Unearned premiums:		
Ceded	\$ (395.8)	(363.9)

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

Assumed	477.7	462.3
<i>Net assumed</i>	<b>\$ 81.9</b>	98.4

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The following table sets forth the reinsurance transactions on the Company's income statements for the Pooling Arrangement between the STFC Pooled Companies and State Auto Mutual for the years ended December 31, 2012, 2011 and 2010:

(\$ millions)	Year ended December 31		
	2012	2011	2010
<b>Written premiums:</b>			
Ceded	\$ (839.9)	(796.2)	(828.9)
Assumed	1,055.3	1,284.6	1,323.5
<b>Earned premiums:</b>			
Ceded	\$ (809.2)	(803.6)	(818.8)
Assumed	1,042.1	1,428.8	1,257.2
<b>Losses and loss expenses incurred:</b>			
Ceded	\$ (575.7)	(701.0)	(579.1)
Assumed	779.4	1,177.7	883.2

*Intercompany Balances*

Pursuant to the Pooling Arrangement, State Auto Mutual receives all premiums and pays all losses and expenses associated with the insurance business produced by the pool participants and then settles the intercompany balances generated by these transactions with the participating companies on a quarterly basis within 45 days following each quarter end. No interest is paid on this balance. When settling the intercompany balances, State Auto Mutual provides the pool participants with full credit for the premiums written and net losses paid during the quarter and retains 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 members on the basis of pool participation. As a result, the Company has an off-balance sheet credit risk related to the balances due to State Auto Mutual from insurers, agents and reinsurers, which are offset by the unearned premium from the respective policies. The Company's share of the premium balances due to State Auto Mutual from agents and insureds at December 31, 2012 and 2011 is approximately \$269.3 million and \$268.5 million, respectively.

**b. Notes Payable**

In May 2003, State Auto Financial formed a Delaware business trust (the Capital Trust) to issue \$15.0 million of mandatorily redeemable preferred capital securities to a third party and \$0.5 million of common securities to State Auto Financial (the capital and common securities are collectively referred to as the Trust Securities). The Capital Trust loaned \$15.5 million, the proceeds from the issuance of its Trust Securities, to State Auto Financial in the form of a Floating Rate Junior Subordinated Debt Securities due in 2033 (the Subordinated Debentures). The Subordinated Debentures and interest accrued thereon are the Capital Trust's only assets. Interest on the Trust Securities are payable quarterly at a rate equal to the three-month LIBOR rate plus 4.20% adjusted quarterly (total 4.51% at December 31, 2012). Because the interest rate and interest payment dates on the Subordinated Debentures are the same as the interest rate and interest payment dates on the Trust Securities, payments from the Subordinated Debentures finance the distributions paid on the Trust Securities. State Auto Financial has the right to redeem the Subordinated Debentures, in whole or in part, on or after May 2008. State Auto Financial has unconditionally and irrevocably guaranteed payment of any required distributions on the capital securities, the redemption price when the capital securities are to be redeemed, and any amounts due if the Capital Trust is liquidated or terminated. State Auto Financial's equity interest in the Capital Trust is included in other invested assets. In accordance with the Consolidation Topic of the FASB ASC, State Auto Financial determined that the business trust is a variable interest entity for which it is not the primary beneficiary and therefore, does not consolidate the Capital Trust with the Company. See

Note 7.

---

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

**c. Notes Receivable**

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. Interest is payable semi-annually at a fixed annual interest rate of 7.00%, with the principal payable in May 2019. There is no prepayment penalty, and no collateral was given as security for the payment of this loan.

Under these agreements, State Auto Financial earned interest of \$4.9 million for each of the three years ended December 31, 2012, 2011 and 2010, respectively. See Note 3 for the notes receivable fair value discussion.

**d. Management Services**

Stateco provides State Auto Mutual and its affiliates investment management services. Investment management income is recognized quarterly based on a percentage of the average fair value of investable assets and the equity portfolio performance of each company managed. Revenue related to these services amounted to \$2.9 million, \$1.9 million and \$1.6 million in 2012, 2011 and 2010, respectively, and is included in other income (affiliates) on the consolidated statements of income.

**7. Notes Payable and Credit Facility**

In 2003, State Auto Financial issued \$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 subsidiaries existing and future indebtedness. See Note 3 for the Senior Notes fair value discussion.

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

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Notes to Consolidated Financial Statements, Continued

## 8. Federal 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 years ended December 31, 2012, 2011 and 2010:

(\$ millions)	2012		2011		2010	
		%	As adjusted	%	As adjusted	%
Amount at statutory rate	\$ 3.7	35	\$ (39.2)	35	\$ 8.5	35
Tax-exempt interest and dividends received deduction	(9.1)	(85)	(10.8)	10	(12.9)	(53)
Patient Protection and Affordable Care Act, Medicare Part D exemption repeal					4.4	18
Other, net	0.5	4	(4.7)	4		
Valuation allowance	4.8	45	103.3	(92)		
<i>Federal income tax (benefit) expense and effective rate</i>	<b>\$ (0.1)</b>	<b>(1)</b>	<b>\$ 48.6</b>	<b>(43)</b>	<b>\$</b>	

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 December 31, 2012 and 2011:

(\$ millions)	December 31,	
	2012	December 31, 2011 As adjusted
Deferred tax assets:		
Unearned premiums not currently deductible	\$ 33.4	32.4
Losses and loss expenses payable discounting	25.2	25.0
Postretirement and pension benefits	39.4	39.4
Realized loss on other-than-temporary impairment	7.5	11.4
Other liabilities	14.5	14.9
Net operating loss carryforward	66.5	56.0
Tax credit carryforward	0.9	0.7
Other	7.9	9.2
<i>Total deferred tax assets</i>	<b>195.3</b>	<b>189.0</b>
Deferred tax liabilities:		
Deferral of policy acquisition costs	32.1	32.1
Net unrealized holding gains on investments	61.7	53.1
<i>Total deferred tax liabilities</i>	<b>93.8</b>	<b>85.2</b>

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

<i>Total net deferred tax assets before valuation allowance</i>	<b>101.5</b>	103.8
Less valuation allowance	<b>100.5</b>	103.3
<i>Net deferred federal income taxes</i>	<b>\$ 1.0</b>	0.5

Deferred income tax assets and liabilities represent the tax effect of the differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. The Company periodically evaluates its deferred tax assets, which requires significant judgment, to determine if they are realizable based upon weighing all available evidence, both positive and negative, including loss carryback potential, past operating results, existence of cumulative losses in the most recent years, projected performance of the business, future taxable income, including the ability to generate capital gains, and prudent and feasible tax planning strategies. In making such judgments, significant weight is given to evidence that can be objectively verified.

---

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

During 2011, the Company determined that a valuation allowance should be established due to the magnitude of the catastrophe losses from unprecedented storms experienced industry wide. At December 31, 2012 and 2011, the Company recorded a valuation allowance of \$100.5 million and \$103.3 million, respectively. The 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.

At December 31, 2012, \$52.0 million of the Company's net operating loss carryforwards, if not used will expire in 2031 with the remaining expiring in 2032.

At December 31, 2012, the Company carried no balance for uncertain tax positions. The Company had no accrual for the payment of interest and penalties at December 31, 2012 or 2011.

State Auto Financial and its subsidiaries file a consolidated U.S. federal income tax return. State Auto Financial and its subsidiaries also file in various state jurisdictions. The Company is no longer subject to U.S. federal or state and local income tax examinations by tax authorities for years before 2009. The federal income tax audit for the 2008 and 2009 returns was concluded in 2012 with an additional refund of \$1.1 million.

**9. Pension and Postretirement Benefit Plans**

The Company, through the employees of State Auto P&C, provides management and operation services under management agreements for all insurance and non-insurance affiliates. The annual periodic costs related to the Company's benefit plans are allocated to affiliated companies based on allocations pursuant to intercompany management agreements including the Pooling Arrangement for insurance subsidiaries and affiliates party to this agreement.

The Company provides a defined benefit pension plan for its eligible employees. Substantially all Company employees hired prior to January 1, 2010 become eligible to participate the year after becoming 20 years of age and vest with 5 years of credited service or attained age 65. The Company's policy is to fund pension costs in accordance with the requirements of the Employee Retirement Income Security Act of 1974. Benefits are determined by applying factors specified in the plan to a participant's defined average annual compensation.

The Company also provides a postretirement benefit plan including certain health care and life insurance benefits for certain eligible retired employees. On November 4, 2011, the postretirement benefit plan was amended to change eligibility requirements for participation of employees and certain retirees, resulting in a \$93.8 million negative plan amendment. In addition, a curtailment gain resulted and the Company's portion recognized was \$14.9 million.

The defined benefit pension and postretirement benefit plans are referred to herein as the benefit plans.



## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The following table sets forth information regarding the pension and postretirement benefit plans change in benefit obligation, plan assets and funded status at December 31, 2012 and 2011:

(\$ millions)	Pension		Postretirement	
	2012	2011	2012	2011
<b>Change in benefit obligation:</b>				
Benefit obligation at beginning of year	\$ 229.6	282.8	\$ 27.1	119.4
Plan amendments				(93.8)
Service cost	7.8	10.5		5.2
Interest cost	9.9	15.2	1.1	5.7
Actuarial loss (gain)	10.6	52.5	(1.6)	7.4
Benefits paid	(11.8)	(16.0)	(1.5)	(2.3)
Impact of pooling change, December 31, 2011		(115.4)		(14.5)
<i>The Company's portion of benefit obligation at end of year</i>	<b>\$ 246.1</b>	229.6	<b>\$ 25.1</b>	27.1
<b>Change in plan assets available for plan benefits:</b>				
Fair value of plan assets available for plan benefits at beginning of year	\$ 147.7	219.6	\$ 1.8	2.7
Employer contribution	13.0	15.0		
Actual return on plan assets	13.3	8.6		0.1
Benefits paid	(11.8)	(16.0)		
Impact of pooling change, December 31, 2011		(79.5)		(1.0)
<i>The Company's portion of fair value of plan assets at end of year</i>	<b>\$ 162.2</b>	147.7	<b>\$ 1.8</b>	1.8
Supplemental executive retirement plan	(5.8)	(5.6)		
<i>Funded status at end of year</i>	<b>\$ (89.7)</b>	(87.5)	<b>\$ (23.3)</b>	(25.3)
Accumulated benefit obligation end of year	<b>\$ 223.0</b>	207.1		

No assets are expected to be returned during the fiscal year ending December 31, 2012.

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

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

### Notes to Consolidated Financial Statements, Continued

The following table sets forth the Company's share of the amounts included in accumulated other comprehensive income (loss) that have not been recognized in net periodic cost at December 31, 2012 and 2011:

<i>(\$ millions)</i>	December 31	
	2012	2011
Prior service benefit	\$ (75.6)	(80.9)
Net actuarial loss	135.7	136.2
<b>Total</b>	<b>\$ 60.1</b>	<b>55.3</b>

The following table sets forth the Company's share of amortization expected to be recognized for the year ending December 31, 2013:

<i>(\$ millions)</i>	2013
Prior service benefit	\$ (5.3)
Net actuarial loss	9.0
<b>Total</b>	<b>\$ 3.7</b>

The following table sets forth information regarding the Company's share of pension and postretirement benefit plans' components of net periodic cost for the years ended December 31, 2012, 2011 and 2010:

<i>(\$ millions)</i>	Pension			Postretirement		
	2012	2011	2010	2012	2011	2010
<b>Components of net periodic cost:</b>						
Service cost	\$ 7.8	8.5	8.7	\$	4.1	3.7
Interest cost	9.9	12.3	12.0	1.1	5.1	5.0
Expected return on plan assets	(11.7)	(14.6)	(13.9)	(0.1)	(0.2)	(0.2)
Amortization of prior service cost (benefit)	0.3	0.3	0.3	(5.5)	(2.1)	(1.4)
Amortization of net actuarial loss	6.7	7.0	7.7	1.1	0.3	0.1
<b>Net periodic cost (benefit)</b>	<b>13.0</b>	<b>13.5</b>	<b>14.8</b>	<b>(3.4)</b>	<b>7.2</b>	<b>7.2</b>
<i>Curtailement gain</i>						(1.6)
<b>Net periodic cost (benefit)</b>	<b>\$ 13.0</b>	<b>13.5</b>	<b>14.8</b>	<b>\$ (3.4)</b>	<b>7.2</b>	<b>5.6</b>



STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

The following table sets forth the Company's share of the benefit payments, which reflect expected future service, expected to be paid:

<i>(\$ millions)</i>	Pension	Postretirement
2013	\$ 8.5	\$ 2.0
2014	8.8	2.0
2015	9.2	2.0
2016	9.7	1.9
2017	10.2	1.9
2018 - 2022	62.8	8.5

The postretirement plan's gross benefit payments for 2012 were \$2.7 million, including the prescription drug benefits. The postretirement plan's subsidy related to Medicare Prescription Drug Improvement and Modernization Act of 2003 was \$0.5 million for 2012 and estimates future annual subsidies to be approximately \$0.3 million.

The following table sets forth the weighted average assumptions used to determine the benefit plans' obligations at December 31, 2012 and 2011:

	Pension		Postretirement	
	2012	2011	2012	2011
Benefit obligations weighted-average assumptions:				
Discount rate	4.05%	4.40%	4.05%	4.40%
Rates of increase in compensation levels	4.00	4.00		

The following table sets forth the weighted average assumptions used to determine the benefit plans' net periodic cost for the years ended December 31, 2012, 2011 and 2010:

	Pension			Postretirement		
	2012	2011	2010	2012	2011	2010
Weighted-average assumptions:						
Discount rate			6.00%/		5.50%/	
Expected long-term rate of return on assets	4.40%	5.50%	5.75% <sup>(2)</sup>	4.40%	4.75% <sup>(1)</sup>	6.00%
Rates of increase in compensation levels	4.00	4.00	4.00			

(1) Due to the curtailment resulting from the postretirement benefit plan amendment, the expense was remeasured at November 1, 2011, using discount rate of 4.75%.

(2) Due to the curtailment resulting from the employee one-time pension benefit election, the expense was remeasured at May 31, 2010, using discount rate of 5.75%.

The benefit plans' obligations are long-term in nature and consequently the investment strategies have a long-term time horizon. In establishing the long-term rate of return assumption on plan assets, management, along with its pension consulting actuary, reviews the historical performance of the plan assets and the stability in the mix of the investment portfolio. The expected inflation rate and expected real rates of return of applicable asset classes are then determined to assist in setting appropriate assumptions.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Notes to Consolidated Financial Statements, Continued

The following table sets forth the assumed health care cost trend rates used for the years ended December 31, 2012, 2011 and 2010:

		Postretirement	
	2012	2011	2010
Assumed health care cost trend rates:			
Health care cost trend rate assumed for the next year	10.00%	10.00%	10.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2017	2016	2015

The assumed health care cost trend rates have a significant effect on the amounts reported for the postretirement plan. The following table sets forth the effects of a one percentage point change in assumed health care cost trend rates for the year ended December 31, 2012:

(\$ millions)	Postretirement	
	Increase	(Decrease)
One percentage point change:		
Effect on total service and interest cost	\$ 0.1	\$ (0.1)
Effect on accumulated postretirement benefit obligation	3.2	(2.8)

The benefit plans' investment policy objective is to preserve the investment principal while generating income and appreciation in fair value to meet the benefit plans' obligations. The benefit plans' investment strategy and risk tolerance is balanced between meeting cash obligation requirements and a long-term relatively high risk tolerance. Since the nature and timing of the benefit plans' liabilities and cash requirements are predictable, the liquidity requirements are somewhat moderate. One of the goals of diversifying the benefit plans' portfolio among different asset classes is the elimination of concentration of risk in one asset class. Management has investment policy guidelines with respect to limiting the ownership in any single debt or equity issuer, and the international private equity investments are composed of numerous securities to reduce our exposure to a single issuer. The following table sets forth the asset allocation targets, as a percentage of total fair value, which are used as a guide by management when allocating funds as they become available.

	Asset allocation target (0 to 100%)
Asset Category:	
Fixed maturity	36%
U.S. large-cap equity	33
U.S. small-cap equity	14
International equity	12
Emerging market equity	5

*Total*

100%

See Note 3 for the valuation methods used by the Company for each type of financial instrument the plans hold that are carried at fair value. There were no transfers between level categorizations during the years ended December 31, 2012 and 2011.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

The following tables set forth the Company's share of pension plan's available-for-sale securities within the fair value hierarchy at December 31, 2012 and 2011:

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
At December 31, 2012:				
<b>Fixed maturities:</b>				
U.S. treasury securities and obligations of U.S. government agencies	\$ 30.4		30.4	
Corporate securities	7.4		7.4	
U.S. government agencies mortgage-backed securities	13.9		13.9	
<b>Total fixed maturities</b>	<b>51.7</b>		<b>51.7</b>	
<b>Equity securities:</b>				
Large-cap securities	60.8	60.8		
Small-cap securities	24.1	24.1		
<b>Total equity securities</b>	<b>84.9</b>	<b>84.9</b>		
International instruments	20.0		20.0	
Short-term money market funds	4.1	4.1		
<b>Total pension plan investments</b>	<b>\$ 160.7</b>	<b>89.0</b>	<b>71.7</b>	

(\$ millions)

Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)



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

At December 31, 2011:

<b>Fixed maturities:</b>			
U.S. treasury securities and obligations of U.S. government agencies	\$ 25.2		25.2
Corporate securities	10.9		10.9
U.S. government agencies mortgage-backed securities	17.8		17.8
<i>Total fixed maturities</i>	53.9		53.9
<b>Equity securities:</b>			
Large-cap securities	51.5	51.5	
Small-cap securities	20.7	20.7	
<i>Total equity securities</i>	72.2	72.2	
International instruments	15.9		15.9
Short-term money market funds	3.8	3.8	
<i>Total pension plan investments</i>	\$ 145.8	76.0	69.8

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

The following tables set forth the Company's share of the postretirement plan's available-for-sale securities within the fair value hierarchy at December 31, 2012 and 2011:

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
At December 31, 2012:				
<b>Fixed maturities:</b>				
U.S. treasury securities and obligations of U.S. government agencies	\$ 0.5		0.5	
Corporate securities	0.2		0.2	
<i>Total fixed maturities</i>	<b>0.7</b>		<b>0.7</b>	
<b>Equity securities:</b>				
Large-cap securities	0.7	0.7		
<i>Total equity securities</i>	<b>0.7</b>	<b>0.7</b>		
Short-term money market funds	0.5	0.5		
<i>Total postretirement plan investments</i>	<b>\$ 1.9</b>	<b>1.2</b>	<b>0.7</b>	

(\$ millions)

Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)

At December 31, 2011:

<b>Fixed maturities:</b>			
U.S. treasury securities and obligations of U.S. government agencies	\$ 1.4		1.4
Corporate securities	0.2		0.2
<i>Total fixed maturities</i>	1.6		1.6
Short-term money market funds	0.2	0.2	
<i>Total postretirement plan investments</i>	\$ 1.8	0.2	1.6

The actuarially prepared funding amount to the pension plan ranges from the minimum amount the Company would be required to contribute to the maximum amount that would be deductible for tax purposes. Contributed amounts in excess of the minimum amounts are deemed voluntary. Amounts in excess of the maximum amount would be subject to an excise tax and may not be deductible for tax purposes. The Company's share of expected contributions during 2013 is approximately \$13.0 million.

The Company maintains a defined contribution plan that covers substantially all employees of the Company. The Company matches the first 1% of contributions of participants' salary at the rate of one dollar for each dollar contributed. Participant contributions of 2% to 6% are matched at a rate of 50 cents for each dollar contributed. In addition, the Company contributes a percentage of the employee's annual income for those employees hired on or after January 1, 2010, and for those employees hired prior to January 1, 2010 who chose to freeze their existing accrued pension benefit effective June 30, 2010. The Company's share of the expense under the plan totaled \$4.5 million, \$4.8 million and \$3.3 million for 2012, 2011 and 2010, respectively.

## 10. Stockholders' Equity

### a. Dividend Restrictions and Statutory Financial Information

State Auto P&C, Milbank and SA Ohio are subject to regulations and restrictions under which payment of dividends from statutory surplus can be made to State Auto Financial during the year without prior approval of regulatory authorities. Pursuant to these rules, approximately \$62.6 million is available for payment to State Auto Financial from its insurance subsidiaries in 2013 without prior approval. State Auto Financial received dividends from its insurance subsidiaries in the amount of \$20.0 million, \$0 and \$56.4 million in 2012, 2011 and 2010, respectively.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

The following tables set forth reconciliations of statutory capital and surplus and net income, as determined using SAP, to the amounts included in the accompanying consolidated financial statements:

<i>(\$ millions)</i>	2012	2011 As adjusted
Statutory capital and surplus of insurance subsidiaries	<b>\$ 630.1</b>	622.3
Net liabilities of non-insurance parent and affiliates	<b>(74.8)</b>	(74.2)
	<b>555.3</b>	548.1
Increases (decreases):		
Deferred acquisition costs	<b>91.7</b>	91.7
Postretirement and pension benefits	<b>6.6</b>	4.6
Deferred federal income taxes	<b>(38.0)</b>	(33.4)
Fixed maturities at fair value	<b>128.5</b>	117.0
Other, net	<b>(6.9)</b>	(4.2)
<i>Stockholders' equity per accompanying consolidated financial statements</i>	<b>\$ 737.2</b>	723.8

<i>(\$ millions)</i>	Year ended December 31		
	2012	2011 As adjusted	2010 As adjusted
Statutory net income (loss) of insurance subsidiaries	<b>\$ 5.5</b>	(64.6)	16.9
Net income of non-insurance parent and affiliates	<b>0.2</b>	1.9	2.3
	<b>5.7</b>	(62.7)	19.2
(Decreases) increases:			
Deferred acquisition costs		(26.8)	22.8
Postretirement and pension benefits	<b>5.3</b>	(2.5)	(18.4)
Deferred federal income taxes	<b>(3.3)</b>	(59.5)	4.7
Share-based compensation expense	<b>(2.7)</b>	(2.9)	(3.0)
Other, net	<b>5.7</b>	(6.3)	(0.9)
<i>Net income(loss) per accompanying consolidated financial statements</i>	<b>\$ 10.7</b>	(160.7)	24.4

11. Preferred Stock

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

State Auto Financial has two authorized classes of preferred stock. For both classes, upon issuance, the Board of Directors has authority to fix and determine the significant features of the shares issued, including, among other things, the dividend rate, redemption price, redemption rights, conversion features and liquidation price payable in the event of any liquidation, dissolution, or winding up of the affairs of State Auto Financial.

The Class A preferred stock is not entitled to voting rights until, for any period, dividends are in arrears in the amount of six or more quarterly dividends.

### **12. Share-Based Compensation**

The Company maintains share-based compensation plans for key employees and outside, or non-employee, directors. The share-based compensation plan for key employees is the State Auto Financial Corporation 2009 Equity Compensation Plan (the Equity Plan ). This plan replaced the previous equity plan which expired on July 1, 2010. The stock-based compensation plan for outside directors is the Outside Directors Restricted Share Unit Plan (the RSU Plan ).

---

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The Company's share-based compensation plans authorize the granting of various equity-based incentives including stock options, restricted stock and restricted share units to employees and non-employee directors and agents. The expense for these equity-based incentives is based on their fair value at the date of grant and amortized over their vesting period. The fair value of each stock option is estimated on the date of grant using the Black-Scholes closed-form pricing model. The pricing model requires assumptions such as the expected life of the option and expected volatility of the Company's stock over the expected life of the option, which significantly impacts the assumed fair value. The Company uses historical data to determine these assumptions and if these assumptions change significantly for future grants, share-based compensation expense will fluctuate in future periods.

*Equity Plan*

The Equity Plan provides for the award of qualified and nonqualified stock options, restricted shares, performance shares, performance units and other stock-based awards. The Company has reserved 2.0 million common shares under the Equity Plan. As of December 31, 2012, a total of 0.5 million common shares are available for issuance under the Equity Plan. The Equity Plan provides that (i) no more than 33% of the common shares authorized for issuance under the Equity Plan may be granted in the form of awards other than stock options, (ii) the maximum number of common shares subject to awards of stock options, restricted shares and performance shares that may be granted in any calendar year is equal to 1.5% of the total number of common shares of the Company outstanding as of December 31 of the prior year, and (iii) the maximum number of common shares subject to awards of stock options, restricted shares and performance shares that may be granted in any calendar year to any one individual is 250,000 shares. The Equity Plan automatically terminates on May 8, 2019.

The Equity Plan provides that qualified stock options may be granted at an option price not less than the fair market value of the common shares at the date of grant and that nonqualified stock options may be granted at any price determined by the Compensation Committee of the Board of Directors. Options granted generally vest over a three-year period, with one-third of the options vesting on each anniversary of the grant date, and must be exercised no later than ten years from the date of grant. Stock options granted under the Equity Plan for 2012, 2011 and 2010 were 0.3 million, 0.6 million and 0.6 million, respectively.

The Equity Plan provides for the granting of restricted shares subject to a vesting schedule based on the employee's continued employment ( Restriction Period ), for which vesting is generally on the third anniversary after the date of grant. The Company recognizes compensation expense based on the number of restricted shares granted at the then grant date fair value over the Restriction Period.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The following table sets forth the status of the Company's non-vested and vested restricted shares and changes for the years ended December 31, 2012, 2011 and 2010:

	2012		2011		2010	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of year	33,887	\$ 17.92	17,180	\$ 18.78	32,000	\$ 29.98
Granted	21,526	13.53	16,707	17.03	17,180	18.78
Vested					(32,000)	29.98
<i>Outstanding, end of year</i>	<b>55,413</b>	<b>\$ 16.21</b>	33,887	\$ 17.92	17,180	\$ 18.78

As of December 31, 2012, there was \$0.3 million of total unrecognized compensation cost related to non-vested restricted share compensation arrangements. The remaining cost is expected to be recognized over a period of 2.25 years.

*Employee Stock Purchase Plan*

The Company also has a broad-based employee stock purchase plan under which employees of the Company may choose at two different specified time intervals each year to have up to 6% of their annual base earnings withheld to purchase the Company's common shares. The purchase price of the common shares is 85% of the lower of its beginning-of-interval or end-of-interval market price. The Company has reserved 3.4 million common shares under this plan. As of December 31, 2012, a total of 3.0 million common shares have been purchased under this plan. This plan remains in effect until terminated by the Board of Directors.

*Outside Directors Plan*

The RSU Plan is an unfunded deferred compensation plan which currently provides each outside director with an award of 1,400 restricted share units (the "RSU award") following each annual meeting of shareholders. The amount of the award may change from year to year, based on the provision described below. The RSU awards are fully vested upon grant. RSU awards are not common shares of the Company and, as such, no participant has any rights as a holder of common shares under the RSU Plan. RSU awards represent the right to receive an amount, payable in cash or common shares of the Company, as previously elected by the outside director, equal to the value of a specified number of common shares of the Company at the end of the restricted period. Such election may be changed within the constraints set forth in the RSU Plan. The restricted period for the RSU awards begins on the date of grant and expires on the date the outside director retires from or otherwise terminates service as a director of the Company. During the restricted period, outside directors are credited with dividends, equivalent in value to those declared and paid on the Company's common shares, on all RSU awards granted to them. At the end of the restricted period, outside directors receive distributions of their RSU awards either (i) in a single lump sum payment, or (ii) in annual installment payments over a five- or ten-year period, as previously elected by the outside director. The administrative committee for the RSU Plan (currently the Company's Compensation Committee) retains the right to increase the annual number of RSU awards granted to each outside director to as many as 5,000 or to decrease such annual number to not less than 500, without seeking shareholder approval, if such increase or decrease is deemed appropriate by the administrative committee to maintain director compensation at appropriate levels. The RSU Plan automatically terminates on May 31, 2015. The

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

Company accounts for the RSU Plan as a liability plan. There were 26,480 RSUs, 23,928 RSUs, and 24,268 RSUs granted in 2012, 2011 and 2010, respectively.



## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

During 2012 and 2011, common shares valued at approximately \$39,000 and \$30,000, respectively, were distributed by the Company under the RSU Plan.

*Stock Options*

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes closed-form pricing model. The following tables present the weighted-average assumptions used in the option pricing model for options granted to employees and non-employees (independent insurance agencies) during 2012, 2011 and 2010. The expected life of the options for employees represents the period of time the options are expected to be outstanding and is based on historical trends. For non-employees the expected life of the option approximates the remaining contractual term of the option. The expected stock price volatility is based on the historical volatility of the Company's stock for a period approximating the expected life and the expected dividend yield is based on the Company's most recent period's dividend payout. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and has a term approximating the expected life of the option.

The fair value of share-based awards granted to employees was estimated at the date of grant using the Black-Scholes option-pricing model. The following table sets forth the weighted average fair values and related assumptions for options granted for the years ended December 31, 2012, 2011 and 2010:

	2012	2011	2010
Fair value per share	\$ 3.46	\$ 4.69	\$ 5.40
Expected dividend yield	4.41%	3.51%	3.28%
Risk free interest rate	1.10%	2.50%	2.50%
Expected volatility factor	41.50%	34.90%	36.80%
Expected life in years	5.4	6.3	6.1

The following table sets forth the Company's total stock option activity and related information for these plans for the years ended December 31, 2012, 2011 and 2010:

	2012		2011		2010	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding, beginning of year	3.8	\$ 22.79	3.4	\$ 23.53	3.1	\$ 24.02
Granted	0.4	13.54	0.6	16.98	0.6	18.74
Exercised		14.49		16.40	(0.2)	14.54
Canceled	(0.3)	17.95	(0.2)	18.94	(0.1)	24.73
<i>Outstanding, end of year</i>	<b>3.9</b>	<b>\$ 22.25</b>	3.8	\$ 22.79	3.4	\$ 23.53

Intrinsic value for stock options is defined as the difference between the current market value and the grant price. For the years ended December 31, 2012, 2011 and 2010, the total intrinsic value of stock options exercised was \$0, \$0.1 million and \$1.4 million, respectively. The tax benefit for tax deductions from share-based awards totaled \$0 for the years ended December 31, 2012 and 2011 and \$0.3 million for the year ended December 31, 2010.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

The following table sets forth information pertaining to the total options outstanding and exercisable at December 31, 2012:

<i>(Options in millions)</i>		Options Outstanding			Options Exercisable	
		Number	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price
Range of Exercise Prices:						
\$10.01	\$20.00	2.1	6.3	\$ 16.66	1.1	\$ 17.23
\$20.01	\$30.00	1.1	3.8	27.17	1.1	27.26
Greater than \$30.00		0.7	2.4	32.11	0.7	32.11
		3.9	4.9	\$ 22.25	2.9	\$ 24.29

Aggregate intrinsic value for total options outstanding at December 31, 2012 was \$3.4 million. Aggregate intrinsic value for total options exercisable at December 31, 2012 was \$0.1 million.

Compensation expense recognized during 2012, 2011 and 2010 was \$3.5 million, \$3.2 million and \$3.7 million, respectively. Share-based compensation is recognized as a component of loss and loss adjustment expense and acquisition and operating expense in a manner consistent with other employee compensation. As of December 31, 2012, there was \$2.2 million of total unrecognized compensation cost related to option-based compensation arrangements granted under the plans. The remaining cost is expected to be recognized over a period of three years.

13. Net Earnings (Loss) Per Common Share

The following table sets forth the compilation of basic and diluted net (loss) earnings per common share for the years ended December 31, 2012, 2011 and 2010:

<i>(millions, except per share amounts)</i>	2012	2011	2010
		As adjusted	As adjusted
Numerator:			
Net earnings (loss) for basic net earnings per common share	\$ 10.7	(160.7)	24.4
Effect of dilutive share-based awards	0.3		0.2
<i>Adjusted net earnings (loss) for dilutive net (loss) earnings per common share</i>	\$ 11.0	(160.7)	24.6
Denominator:			
	40.4	40.1	40.0

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

Weighted average shares for basic net earnings (loss) per common share

Effect of dilutive share-based awards	<b>0.1</b>	0.1	0.1
---------------------------------------	------------	-----	-----

*Adjusted weighted average shares for diluted net earnings(loss) per common share*

	<b>40.5</b>	40.2	40.1
--	-------------	------	------

Basic net earnings (loss) per common share	<b>\$ 0.26</b>	(4.00)	0.61
--	----------------	--------	------

Diluted net earnings (loss) per common share	<b>\$ 0.27</b>	(4.00)	0.62
--	----------------	--------	------

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

The following table sets forth the options to purchase shares of common stock that were not included in the computation of diluted earnings (loss) per share because the exercise price of the options was greater than the average market price or their inclusion would have been antidilutive for the years ended December 31, 2012, 2011 and 2010:

<i>(in millions)</i>	<b>2012</b>	2011	2010
Number of options	<b>3.7</b>	3.3	2.7

**14. Reportable Segments**

Effective January 1, 2011, the Company had four reportable segments: personal insurance, business insurance, specialty insurance (the insurance segments) and investment operations. The 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 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, 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 6), the Company changed its reportable insurance segments from personal and business insurance to the three insurance 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 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.

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

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

The following table sets forth financial information regarding the Company's reportable segments for the years ended December 31, 2012, 2011 and 2010:

<i>(\$ millions)</i>	<b>2012</b>	2011 As adjusted	2010 As adjusted
<b>Revenues from external sources:</b>			
Insurance segments			
Personal insurance	<b>\$ 469.8</b>	800.6	798.5
Business insurance	<b>327.2</b>	379.0	383.5
Specialty insurance	<b>245.1</b>	249.2	75.2
<i>Total insurance segments</i>	<b>1,042.1</b>	1,428.8	1,257.2
Investment operations segment			
Net investment income	<b>75.4</b>	85.4	80.8
Net realized capital gains	<b>28.8</b>	38.1	11.0
<i>Total investment operations segment</i>	<b>104.2</b>	123.5	91.8
<i>Total revenue from reportable segments</i>	<b>1,146.3</b>	1,552.3	1,349.0
All other	<b>3.8</b>	1.4	6.1
<i>Total revenues from external sources</i>	<b>1,150.1</b>	1,553.7	1,355.1
Intersegment revenues	<b>9.5</b>	10.5	9.8
<b>Total revenues</b>	<b>1,159.6</b>	1,564.2	1,364.9
Reconciling items:			
Eliminate intersegment revenues	<b>(9.5)</b>	(10.5)	(9.8)
<i>Total consolidated revenue</i>	<b>\$ 1,150.1</b>	1,553.7	1,355.1
<b>Segment loss before federal income tax:</b>			
Insurance segments:			
Personal insurance SAP underwriting loss	<b>\$ (1.6)</b>	(67.4)	(9.3)
Business insurance SAP underwriting loss	<b>(42.3)</b>	(70.9)	(24.0)
Specialty insurance SAP underwriting loss	<b>(48.1)</b>	(46.6)	(28.5)
<i>Total insurance segments</i>	<b>(92.0)</b>	(184.9)	(61.8)
Investment operations segment:			
Net investment income	<b>75.4</b>	85.4	80.8
Net realized capital gains	<b>28.8</b>	38.1	11.0
<i>Total investment operations segment</i>	<b>104.2</b>	123.5	91.8

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

All other segments income (loss)	<b>2.0</b>	(0.5)	0.3
Reconciling items:			
GAAP adjustments	<b>7.2</b>	(40.7)	(0.1)
Interest expense on corporate debt	<b>(7.0)</b>	(7.1)	(7.1)
Corporate expenses	<b>(3.8)</b>	(2.4)	1.3
<i>Total consolidated income (loss) before federal income taxes</i>	<b>\$ 10.6</b>	(112.1)	24.4

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Consolidated Financial Statements, Continued

The following table sets forth financial information regarding the Company's reportable segments at December 31, 2012 and 2011:

(\$ millions)	December 31	
	2012	2011 As adjusted
Segment assets:		
Investment operations segment	\$ 2,327.4	\$ 2,585.9
<i>Total segment assets</i>	<b>2,327.4</b>	2,585.9
Reconciling items:		
Corporate assets	150.4	178.5
<i>Total consolidated assets</i>	<b>\$ 2,477.8</b>	\$ 2,764.4

Assets attributed to the investment operations segment include the total investments and cash and cash equivalent categories from the balance sheet. All other assets are corporate assets and are not assigned to a segment.

15. Quarterly Financial Data (unaudited)

The following tables set forth quarterly financial data for 2012 and 2011:

(\$ millions, except per share amounts)	2012			
	For three months ended			
	March 31	June 30	September 30	December 31
Total revenues	\$ 280.3	286.7	286.4	296.7
(Loss) income before federal income taxes	(2.0)	(2.7)	(5.6)	20.9
Net (loss) income	(2.0)	(2.7)	(5.5)	20.9
Earnings (loss) per common share:				
Basic	\$ (0.05)	(0.07)	(0.14)	0.52
Diluted	\$ (0.05)	(0.07)	(0.14)	0.51

  

	2011			
	For three months ended			
	March 31	June 30	September 30	December 31
	As adjusted	As adjusted	As adjusted	As adjusted
Total revenues	\$ 380.2	384.4	388.0	401.1



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

Income (loss) before federal income taxes	15.6	(139.3)	(52.0)	63.6
Net income (loss)	12.8	(214.1)	(58.7)	99.3
Earnings (loss) per common share:				
Basic	\$ 0.32	(5.33)	(1.46)	2.47
Diluted	\$ 0.32	(5.33)	(1.46)	2.46

### 16. Contingencies

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

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Notes to Consolidated Financial Statements, Continued**

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

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

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.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

**Management's Annual Report on Internal Control Over Financial Reporting**

Our management's annual report on internal control over financial reporting required by Item 308(a) of Regulation S-K follows. The attestation report of our independent registered public accounting firm required by Item 308(b) of Regulation S-K is found under the caption "Report of the Independent Registered Public Accounting Firm on Internal Control over Financial Reporting" in Item 8 of this Form 10-K.

The following report is provided by our management on the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act):

1. Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company.
2. Our management has used the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework to evaluate the effectiveness of our internal control over financial reporting. Our management believes that the COSO framework is a suitable framework for its evaluation of our internal control over financial reporting because it is free from bias, permits reasonably qualitative and quantitative measurements of our internal controls, is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of our internal controls are not omitted and is relevant to an evaluation of internal control over financial reporting.
3. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can only provide reasonable assurance with respect to financial reporting.
4. Our management has assessed the effectiveness of our internal control over financial reporting as of December 31, 2012, and has concluded that such internal control over financial reporting was effective.
5. Ernst & Young LLP, the independent registered public accounting firm that audited the consolidated financial statements included in this Form 10-K, has issued their attestation on the Company's internal control over financial reporting, which is included herein.

**Disclosure Controls and Procedures**

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings with the Securities and Exchange Commission.

**Changes in Internal Control over Financial Reporting**

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

**Item 9B. Other information**

None.



**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance**

Information regarding our directors required by Items 401(a) and (d)-(f) of Regulation S-K will be found under the caption **Proposal One: Election of Directors** in our 2013 Proxy Statement, which information is incorporated herein by reference. Information regarding our executive officers required by Items 401(b) and (d)-(f) of Regulation S-K is found under the caption **Executive Officers of the Registrant** at the end of Item 1 of our Form 10-K, which information is also incorporated by reference into this Item 10.

We have a separately-designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. As of March 8, 2013, the members of our Audit Committee were Eileen A. Mallesch, Alexander B. Trevor, David R. Meuse, Thomas E. Markert and Paul S. Williams. Ms. Mallesch is Chairperson of our Audit Committee. Our Board of Directors has determined that Ms. Mallesch is an audit committee financial expert, as that term is defined in Item 407(d)(5) of Regulation S-K, and independent, as that term is defined in Rule 10A-3 of the Exchange Act.

Information regarding the filing of reports of ownership under Section 16(a) of the Exchange Act by our officers and directors and persons owning more than 10% of a registered class of our equity securities required by Item 405 of Regulation S-K will be found under the caption **Section 16(a) Beneficial Ownership Reporting Compliance** in our 2013 Proxy Statement, which information is incorporated herein by reference.

Information concerning the procedures by which shareholders may recommend nominees to our Board of Directors will be found under the caption **Corporate Governance Nomination of Directors** in our 2013 Proxy Statement. There has been no material change to the nomination procedures previously disclosed in the proxy statement for our 2013 annual meeting of shareholders.

Our Board of Directors has adopted a code of ethics that applies to our principal executive officer, principal financial officer, principal accounting officer, controller, and persons performing similar functions. This code of ethics has been posted on our website at [www.StateAuto.com](http://www.StateAuto.com) under **Investor Relations** then **Corporate Governance**. Any amendment (other than any technical, administrative or other non-substantive amendment) to, or waiver from, a provision of this code will be posted on our website described above within four business days following its occurrence.

**Item 11. Executive Compensation**

Our 2013 Proxy Statement will contain information regarding the following matters: information regarding executive compensation required by Item 402 of Regulation S-K will be found under the captions **Board of Directors and Board Committees Compensation of Outside Directors and Outside Director Compensation Table** and **Compensation Discussion and Analysis**; information required by Item 407(e)(4) of Regulation S-K will be found under the caption **Compensation Committee Interlocks and Insider Participation**; information required by Item 407(e)(5) of Regulation S-K will be found under the caption **Compensation Committee Report**. This information is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Information regarding security ownership of certain beneficial owners and management required by Item 403 of Regulation S-K will be found under the caption **Proposal One: Election of Directors** and **Principal Holders of Voting Securities** in our 2013 Proxy Statement, which information is incorporated herein by reference.

Information regarding equity compensation plan information required by Item 201(d) of Regulation S-K will be found under the caption **Equity Compensation Plan Information** in our 2013 Proxy Statement, which information is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

Information regarding certain relationships and related transactions required by Item 404 of Regulation S-K will be found under the caption Related Party Transactions in our 2013 Proxy Statement, which information is incorporated herein by reference.

Information regarding the independence of our directors required by Item 407(a) of Regulation S-K will be found under the caption Corporate Governance Director Independence in our 2013 Proxy Statement, which is incorporated herein by reference.

**Item 14. Principal Accountant Fees and Services**

Information regarding principal accountant fees and services required by Item 9(e) of Schedule 14A will be found under the caption Independent Registered Public Accounting Firm in our 2013 Proxy Statement, which information is incorporated herein by reference.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a)(1) LISTING OF FINANCIAL STATEMENTS

The following consolidated financial statements of the Company are filed as part of this Form 10-K and are included in Item 8:

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2012 and 2011

Consolidated Statements of Income for each of the three years in the period ended December 31, 2012

Consolidated Statements of Comprehensive Income (Loss) for each of the three years in the period ended December 31, 2012

Consolidated Statements of Stockholders Equity for each of the three years in the period ended December 31, 2012

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2012

Notes to Consolidated Financial Statements

(a)(2) LISTING OF FINANCIAL STATEMENT SCHEDULES

The following financial statement schedules of the Company for the years 2012, 2011 and 2010 are included in Item 14(d) following the signatures and should be read in conjunction with our consolidated financial statements contained in our Form 10-K.

Schedule	
Number	Schedule
I.	Summary of Investments Other Than Investments in Related Parties
II.	Condensed Financial Information of Registrant
III.	Supplementary Insurance Information
IV.	Reinsurance
V.	Valuation and Qualifying Accounts

All other schedules and footnotes are omitted because they are not applicable or the required information is included in the consolidated financial statements or notes thereto.



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

(a)(3) LISTING OF EXHIBITS

Exhibit		If incorporated by reference document with which Exhibit was
No.	Description of Exhibit	previously filed with SEC
3.01	State Auto Financial Corporation s Amended and Restated Articles of Incorporation	Included herein
3.02	State Auto Financial Corporation s Amendment to the Amended and Restated Articles of Incorporation	1933 Act Registration Statement No. 33-89400 on Form S-8 (see Exhibit 4(b) therein)
3.03	State Auto Financial Corporation Certificate of Amendment to the Amended and Restated Articles of Incorporation as of June 2, 1998	Form 10-K Annual Report for the year ended December 31, 1998 (see Exhibit 3(A)(3) therein)
3.04	State Auto Financial Corporation s Amended and Restated Code of Regulations	Included herein
3.05	First Amendment to State Auto Financial Corporation s Amended and Restated Code of Regulations as of May 7, 2010	Form 10-Q Quarterly Report for the period ended September 30, 2010 (see Exhibit 3.05 therein)
10.01*	2000 Directors Stock Option Plan of State Auto Financial Corporation	Definitive Proxy Statement on Form DEF 14A, File No. 000-19289, for Annual Meeting of Shareholders held on May 26, 2000 (see Appendix B therein)
10.02*	First Amendment to 2000 Directors Stock Option Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended March 31, 2001 (see Exhibit 10(HH) therein)
10.03*	Second Amendment to 2000 Directors Stock Option Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended September 30, 2001 (see Exhibit 10(KK) therein)
10.04*	Third Amendment to 2000 Directors Stock Option Plan of State Auto Financial Corporation	Form 10-K Annual Report for the year ended December 31, 2001 (see Exhibit 10(EE) therein)
10.05*	Fourth Amendment to 2000 Directors Stock Option Plan of State Auto Financial Corporation	Form 10-K Annual Report for year ended December 31, 2002 (see Exhibit 10(UU) therein)
10.06*	Fifth Amendment to 2000 Directors Stock Option Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2005 (see Exhibit 10.66 therein)
10.07*	Sixth Amendment to the 2000 Directors Stock Option Plan (effective March 7, 2008) of State Auto Financial Corporation	Form 8-K Current Report filed on March 13, 2008 (see Exhibit 10.3 therein)
10.08	Investment Management Agreement between Stateco Financial Services, Inc. and State Automobile Mutual Insurance Company, effective April 1, 1993	Form 10-K Annual Report for the year ended December 31, 1992 (see Exhibit 10 (N) therein)
10.09	First Amendment to the Investment Management Agreement between Stateco Financial Services, Inc. and State Automobile Mutual Insurance Company, effective January 1, 2013	Included herein
10.10	Amended and Restated Exhibit A to the Investment Management Agreement between Stateco Financial Services, Inc. and State Automobile Mutual Insurance Company, effective January 1, 2013	Included herein
10.11	Investment Management Agreement between Stateco Financial Services, Inc. and Meridian Security Insurance Company, effective June 1, 2001	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.17 therein)
10.12	Amended and Restated Exhibit A to the Investment Management Agreement between Stateco Financial Services, Inc. and Meridian Security Insurance Company, effective January 1, 2013	Included herein





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

Exhibit	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.13	Investment Management Agreement between Stateco Financial Services, Inc. and State Auto Florida Insurance Company effective April 1, 2002	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.18 therein)
10.14	Investment Management Agreement between Stateco Financial Services, Inc. and Midwest Security Insurance Company effective January 1, 1997	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.19 therein)
10.15	Amended and Restated Exhibit A to the Investment Management Agreement between Stateco Financial Services, Inc. and Midwest Security Insurance Company, effective January 1, 2013	Included herein
10.16	Investment Management Agreement between Stateco Financial Services, Inc. and Meridian Citizens Mutual Insurance Company effective June 1, 2001	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.20 therein)
10.17	Amended and Restated Exhibit A to the Investment Management Agreement between Stateco Financial Services, Inc. and Meridian Citizens Mutual Insurance Company, effective January 1, 2013	Included herein
10.18	Investment Management Agreement dated March 29, 2007, between Stateco Financial Services, Inc. and Beacon National Insurance Company, First Preferred Insurance Company, Petrolia Insurance Company and Beacon Lloyds Insurance Company	Form 10-Q Quarterly Report for the period ended March 31, 2007 (see Exhibit 10.63 therein)
10.19	Amended and Restated Investment Management Agreement dated as of December 31, 2007, among Stateco Financial Services, Inc. and Patrons Mutual Insurance Company of Connecticut, Patrons Fire Insurance Company of Rhode Island, and Provision State Insurance Company	Form 10-K Annual Report for the year ended December 31, 2007 (see Exhibit 10.22 therein)
10.20	Amended and Restated Investment Management Agreement dated as of December 31, 2007, between Stateco Financial Services, Inc. and Litchfield Mutual Fire Insurance Company	Form 10-K Annual Report for the year ended December 31, 2007 (see Exhibit 10.23 therein)
10.21	Investment Management Agreement between Stateco Financial Services, Inc. and Plaza Insurance Company effective October 1, 2010	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.26 therein)
10.22	Amended and Restated Exhibit A to the Investment Management Agreement between Stateco Financial Services, Inc. and Plaza Insurance Company, effective January 1, 2013	Included herein
10.23	Investment Management Agreement between Stateco Financial Services, Inc. and Rockhill Insurance Company effective October 1, 2010	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.27 therein)
10.24	Amended and Restated Exhibit A to the Investment Management Agreement between Stateco Financial Services, Inc. and Rockhill Insurance Company, effective January 1, 2013	Included herein

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

Exhibit	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.25	Investment Management Agreement between Stateco Financial Services, Inc. and American Compensation Insurance Company and Bloomington Compensation Insurance Company effective October 1, 2010	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.28) therein
10.26	Amended and Restated Exhibit A to the Investment Management Agreement between Stateco Financial Services, Inc. and American Compensation Insurance Company and Bloomington Compensation Insurance Company, effective January 1, 2013	Included herein
10.27	Cost Sharing Agreement among State Auto Property and Casualty Insurance Company, State Automobile Mutual Insurance Company, and State Auto Florida Insurance Company effective January 1, 2003	Form 10-K Annual Report for year ended December 31, 2002 (see Exhibit 10(OO) therein)
10.28	Renewal of Cost Sharing Agreement among State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company and BroadStreet Capital Partners, Inc. effective March 31, 2008	Form 10-K Annual Report for the year ended December 31, 2008 (see Exhibit 10.29 therein)
10.29	Midwest Security Insurance Company Management Agreement amended and restated as of January 1, 2000 by and among State Automobile Mutual Insurance Company, State Auto Property and Casualty Insurance Company and Midwest Security Insurance Company (nka State Auto Insurance Company of Wisconsin)	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.45 therein)
10.30	Management and Operations Agreement, Amended and Restated as of January 1, 2005 by and among State Automobile Mutual Insurance Company, State Auto Financial Corporation, State Auto Property and Casualty Insurance Company, State Auto National Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Ohio, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Meridian Insurance Group, Inc., Farmers Casualty Insurance Company, Stateco Financial Services, Inc., Strategic Insurance Software, Inc., and 518 Property Management and Leasing, LLC	Form 10-Q Quarterly Report for the period ended March 31, 2005 (see Exhibit 10.56 therein)
10.31	First Amendment, made as of April 1, 2007, to Management and Operations Agreement Amended and Restated as of January 1, 2005, by and among State Automobile Mutual Insurance Company, State Auto Financial Corporation, State Auto Property and Casualty Insurance Company, State Auto National Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Ohio, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Meridian Insurance Group, Inc., Farmers Casualty Insurance Company, Stateco Financial Services, Inc., Strategic Insurance Software, Inc., 518 Property Management and Leasing, LLC, State Auto Florida Insurance Company, Beacon National Insurance Company, Beacon Lloyds, Inc., Beacon Lloyds Insurance Company, First Preferred Insurance Company, and Petrolia Insurance Company	Form 10-Q Quarterly Report for the period ended June 30, 2007 (see Exhibit 66.67 therein)

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

Exhibit	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.32	Second Amendment dated as of December 31, 2008, to the Management and Operations Agreement, Amended and Restated as of January 1, 2005, among State Auto Financial Corporation, State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, State Auto National Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Ohio, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Meridian Insurance Group, Inc., Farmers Casualty Insurance Company, Stateco Financial Services, Inc., Strategic Insurance Software, Inc., 518 Property Management and Leasing, LLC, State Auto Florida Insurance Company, Beacon National Insurance Company, Beacon Lloyds, Inc., Beacon Lloyds Insurance Company, Patrons Mutual Insurance Company of Connecticut, Litchfield Mutual Fire Insurance Company, and Provision State Insurance Company	Form 8-K Current Report filed on January 27, 2009 (see Exhibit 10.1 therein)
10.33	Third Amendment, effective as of December 31, 2010, to the Management and Operations Agreement, Amended and Restated as of January 1, 2005, among State Auto Financial Corporation, State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Ohio, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Meridian Insurance Group, Inc., Farmers Casualty Insurance Company, Stateco Financial Services, Inc., Strategic Insurance Software, Inc., 518 Property Management and Leasing, LLC, State Auto Florida Insurance Company, Beacon National Insurance Company, Beacon Lloyds, Inc., Beacon Lloyds Insurance Company, Patrons Mutual Insurance Company of Connecticut and Litchfield Mutual Fire Insurance Company	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.36 therein)
10.34	Consulting Services Agreement dated as of November 1, 2009, by and between State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Farmers Casualty Insurance Company, Milbank Insurance Company, and RTW, Inc.	Form 10-Q Quarterly Report for the period ended September 30, 2009 (see Exhibit 10.01 therein)
10.35	Amended and Restated Appendix B , effective as of January 1, 2013, to the Consulting Service Agreement, dated as of November 1, 2009, by and between State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Farmers Casualty Insurance Company, Milbank Insurance Company, and RTW, Inc.	Included herein

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

Exhibit	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.36	Underwriting Management Agreement effective as of November 20, 2009, by and between Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company, Bloomington Compensation Insurance Company, State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Meridian Security Insurance Company, Milbank Insurance Company, Farmers Casualty Insurance Company, and Risk Evaluation and Design, LLC	Form 8-K Current Report filed on November 25, 2009 (see Exhibit 10.1 therein)
10.37	Management and Operations Agreement, effective as of January 1, 2010, entered into as of February 10, 2010, by and among State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company, Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company, Bloomington Compensation Insurance Company, Rockhill Holding Company, National Environmental Coverage Corporation of the South, LLC, National Environmental Coverage Corporation, RTW, Inc., Rockhill Insurance Services, LLC, Rockhill Underwriting Management, LLC and Risk Evaluation and Design, LLC	Form 8-K Current Report filed on February 16, 2010 (see Exhibit 10.3 therein)
10.38	Amended and Restated Management and Operations Agreement, effective as of January 1, 2011, by and among State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company, Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company, Bloomington Compensation Insurance Company, Rockhill Holding Company, National Environmental Coverage Corporation of the South, LLC, National Environmental Coverage Corporation, RTW, Inc., Rockhill Insurance Services, LLC and Rockhill Underwriting Management, LLC.	Form 8-K Current Report filed on January 7, 2011 (see Exhibit 10.2 therein)
10.39	First Amendment, effective as of January 1, 2013, to Amended and Restated Management and Operations Agreement, effective as of January 1, 2011 by and among State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company, Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company, Bloomington Compensation Insurance Company, Rockhill Holding Company, National Environmental Coverage Corporation of the South, LLC, National Environmental Coverage Corporation, RTW, Inc., Rockhill Insurance Services, LLC and Rockhill Underwriting Management, LLC.	Included herein

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

Exhibit		
No.	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.40	Reinsurance Pooling Agreement, Amended and Restated effective as of January 1, 2010, entered into as of February 10, 2010, by and among State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Wisconsin, Farmers Casualty Insurance Company, State Auto Insurance Company of Ohio, State Auto National Insurance Company, State Auto Florida Insurance Company, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Patrons Mutual Insurance Company of Connecticut, Litchfield Mutual Fire Insurance Company, and Beacon National Insurance Company	Form 8-K Current Report filed on February 16, 2010 (see Exhibit 10.1 therein)
10.41	First Amendment, effective December 31, 2010, to Reinsurance Pooling Agreement Amended and Restated as of January 1, 2010, by and among State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Wisconsin, Farmers Casualty Insurance Company, State Auto Insurance Company of Ohio, State Auto Florida Insurance Company, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Patrons Mutual Insurance Company of Connecticut, Litchfield Mutual Fire Insurance Company, and Beacon National Insurance Company	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.49 therein)
10.42	Reinsurance Pooling Agreement Amended and Restated as of January 1, 2011, entered into as of January 3, 2011, by and among State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Wisconsin, Farmers Casualty Insurance Company, State Auto Insurance Company of Ohio, State Auto Florida Insurance Company, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Patrons Mutual Insurance Company of Connecticut, Litchfield Mutual Fire Insurance Company, Beacon National Insurance Company, Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company and Bloomington Compensation Insurance Company	Form 8-K Current Report filed on January 7, 2011 (see Exhibit 10.1 therein)

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

Exhibit		
No.	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.43	First Amendment, effective December 31, 2011, to Reinsurance Pooling Agreement Amended and Restated as of January 1, 2011 by and among State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Milbank Insurance Company, State Auto Insurance Company of Wisconsin, Farmers Casualty Insurance Company, State Auto Insurance Company of Ohio, State Auto Florida Insurance Company, Meridian Security Insurance Company, Meridian Citizens Mutual Insurance Company, Patrons Mutual Insurance Company of Connecticut, Litchfield Mutual Fire Insurance Company, Beacon National Insurance Company, Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company and Bloomington Compensation Insurance Company	Form 10-K Annual Report for year ended December 31, 2011 (see Exhibit 10.45 therein)
10.44	Homeowners Quota Share Reinsurance Contract between State Automobile Mutual Insurance Company (on behalf of itself and insurance subsidiaries and affiliates now under its ownership, control or management, including insurance subsidiaries of State Auto Financial Corporation) and a syndicate of reinsurers effective December 31, 2011 at 11:59 p.m.	Form 10-K Annual Report for year ended December 31, 2011 (see Exhibit 10.46 therein)
10.45	Commutation and Release Agreement, effective as of January 1, 2010, entered into as of February 10, 2010, between State Automobile Mutual Insurance Company and State Auto National Insurance Company	Form 8-K Current Report filed on February 16, 2010 (see Exhibit 10.2 therein)
10.46	Amended and Restated Declaration of Trust of STFC Capital Trust I, dated as of May 22, 2003	Form 10-Q Quarterly Report for the period ended June 30, 2003 (see 10(XX) therein)
10.47	Indenture dated as of May 22, 2003, for Floating Rate Junior Subordinated Debt Securities Due 2033	Form 10-Q Quarterly Report for the period ended June 30, 2003 (see 10(YY) therein)
10.48	Indenture dated as of November 13, 2003, among State Auto Financial Corporation, as Issuer, and Fifth Third Bank, as Trustee, regarding 6 1/4% Senior Note due 2013	Securities Act Registration Statement on Form S-4 (File No. 333-111507)(see Exhibit 4.01 therein)
10.49	Form of 6 1/4% Senior Note due 2013 (Exchange Note)	Securities Act Registration Statement on Form S-4 (File No. 333-111507)(see Exhibit 4.02 therein)
10.50	Credit Agreement dated as of May 19, 2009, between State Automobile Mutual Insurance Company, as borrower, and Milbank Insurance Company, as lender	Form 8-K Current Report filed on May 26, 2009 (see Exhibit 10.1 therein)
10.51	Credit Agreement dated as of May 8, 2009, between State Automobile Mutual Insurance Company, as borrower, and State Auto Property & Casualty Insurance Company, as lender	Form 8-K Current Report filed on May 13, 2009 (see Exhibit 10.1 therein)
10.52	Credit Agreement dated as of September 29, 2011, among State Auto Financial Corporation, as borrower, a syndicate of financial institutions, as the lenders party thereto, KeyBank National Association, as Administrative Agent, Lead Arranger, Sole Book Runner and Swingline Lender, and JPMorgan Chase Bank, N.A. and PNC BANK, National Association, as Co-Documentation Agents.	Form 8-K Current Report filed on September 30, 2011 (see Exhibit 10.1 therein)

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

Exhibit		
No.	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.53*	Employment Agreement, dated as of December 20, 2011, commencing as of January 1, 2012, among State Auto Financial Corporation, State Auto Property & Casualty Insurance Company, State Automobile Mutual Insurance Company and Robert P. Restrepo, Jr.	Form 10-K Annual Report for year ended December 31, 2011 (see Exhibit 10.55 therein)
10.54*	Executive Agreement dated as of December 20, 2011, among State Auto Financial Corporation, State Automobile Mutual Insurance Company and Robert P. Restrepo, Jr.	Form 10-K Annual Report for year ended December 31, 2011 (see Exhibit 10.57 therein)
10.55*	Employment Agreement (dated as of November 17, 2008), including Amendment to Employment Agreement (dated as of November 30, 2010), among Rockhill Holding Company, State Automobile Mutual Insurance Company and Jessica E. Buss	Form 10-K Annual Report for year ended December 31, 2011 (see Exhibit 10.61 therein)
10.56*	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	Form 10-Q Quarterly Report for the period ended September 30, 2011 (see Exhibit 10.1 therein)
10.57*	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	Form 10-Q Quarterly Report for the period ended September 30, 2011 (see Exhibit 10.2 therein)
10.58*	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	Form 10-Q Quarterly Report for the period ended September 30, 2011 (see Exhibit 10.3 therein)
10.59*	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 Jessica E. Buss	Form 10-K Annual Report for year ended December 31, 2011 (see Exhibit 10.75 therein)
10.60*	Form of Indemnification Agreement between State Auto Financial Corporation and each of its directors	Form 8-K Current Report filed on November 20, 2008 (see Exhibit 99.1 therein)
10.61*	Indemnification Agreement dated as of November 14, 2008, between State Auto Financial Corporation and Robert P. Restrepo, Jr.	Form 8-K Current Report filed on May 13, 2009 (see Exhibit 10.2 therein)
10.62*	Officer Indemnification Agreement dated as of May 8, 2009, between State Auto Financial Corporation and Steven E. English	Form 8-K Current Report filed on May 13, 2009 (see Exhibit 10.3 therein)
10.63*	Officer Indemnification Agreement dated as of May 8, 2009, between State Auto Financial Corporation and Clyde H. Fitch, Jr.	Form 8-K Current Report filed on May 13, 2009 (see Exhibit 10.5 therein)
10.64*	Officer Indemnification Agreement dated as of May 8, 2009, between State Auto Financial Corporation and James A. Yano	Form 8-K Current Report filed on May 13, 2009 (see Exhibit 10.6 therein)



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

Exhibit No.	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.65*	Amended and Restated Equity Incentive Compensation Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2005 (see Exhibit 10.60 therein)
10.66*	Amendment Number 1 to the Amended and Restated Equity Incentive Compensation Plan of State Auto Financial Corporation (amendment effective August 15, 2008)	Form 10-K Annual Report for the year ended December 31, 2008 (see Exhibit 10.63 therein)
10.67*	Restricted Share Award Agreement under the Amended and Restated Equity Incentive Compensation Plan dated as of March 2, 2006 between State Auto Financial Corporation and Robert P. Restrepo, Jr.	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.49 therein)
10.68*	Restricted Stock Agreement under the Amended and Restated Equity Incentive Compensation Plan dated as of November 5, 2007, between State Auto Financial Corporation and Clyde H. Fitch	Form 10-K Annual Report for the year ended December 31, 2008 (see Exhibit 10.66 therein)
10.69*	Form of Non-Qualified Stock Option Agreement under the Amended and Restated Equity Incentive Compensation Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2005 (see Exhibit 10.62 therein)
10.70*	Non-Qualified Stock Option Agreement under the Amended and Restated Equity Incentive Compensation Plan of State Auto Financial Corporation dated March 2, 2006 between State Auto Financial Corporation and Robert P. Restrepo, Jr.	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.51 therein)
10.71*	Form of Incentive Stock Option Agreement under the Amended and Restated Equity Incentive Compensation Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2005 (see Exhibit 10.63 therein)
10.72*	2009 Equity Incentive Compensation Plan of State Auto Financial Corporation	Form 8-K Current Report filed on May 13, 2009 (see Exhibit 10.7 therein)
10.73*	Amendment No. 1 to the 2009 Equity Incentive Compensation Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2011 (see Exhibit 10.01 therein)
10.74*	Restricted Stock Agreement under the 2009 Equity Incentive Compensation Plan dated as of March 4, 2010 between State Auto Financial Corporation and Robert P. Restrepo, Jr.	Form 10-Q Quarterly Report for the period ended March 31, 2010 (see Exhibit 10.01 therein)
10.75*	Restricted Stock Agreement under the 2009 Equity Incentive Compensation Plan dated March 3, 2011, between State Auto Financial Corporation and Robert P. Restrepo, Jr.	Form 10-Q Quarterly Report for the period ended March 31, 2011 (see Exhibit 10.01 therein)
10.76*	Restricted Stock Agreement under the 2009 Equity Incentive Compensation Plan dated March 1, 2012, between State Auto Financial Corporation and Robert P. Restrepo Jr.	Form 8-K Current Report filed on May 10, 2012 (see Exhibit 10.1 therein)
10.77*	Outside Directors Restricted Share Unit Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2005 (see Exhibit 10.61 therein)
10.78*	First Amendment to the Outside Directors Restricted Share Unit Plan of State Auto Financial Corporation	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.54 therein)

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

Exhibit		If incorporated by reference document with which Exhibit was previously filed with SEC
No.	Description of Exhibit	
10.79*	Second Amendment to the Outside Directors Restricted Share Unit Plan of State Auto Financial Corporation	Form 10-K Annual Report for the year ended December 31, 2008 (see Exhibit 10.72 therein)
10.80*	Third Amendment to the Outside Directors Restricted Share Unit Plan of State Auto Financial Corporation	Form 10-K Annual Report for the year ended December 31, 2008 (see Exhibit 10.73 therein)
10.81*	Fourth Amendment to the Outside Directors Restricted Share Unit Plan of State Auto Financial Corporation effective November 1, 2010	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.89 therein)
10.82*	Form of Restricted Share Unit Agreement for the Outside Directors Restricted Share Unit Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2005 (see Exhibit 10.64 therein)
10.83*	Form of Designation of Beneficiary for the Outside Directors Restricted Share Unit Plan of State Auto Financial Corporation	Form 10-Q Quarterly Report for the period ended June 30, 2005 (see Exhibit 10.65 therein)
10.84*	Supplemental Retirement Plan for Executive Employees of State Auto Insurance Companies (Restatement) effective as of January 1, 1994	Form 10-K Annual Report for the year ended December 31, 1997 (see Exhibit 10(HH) therein)
10.85*	Amendment No. 1, effective as of January 1, 2008, to Supplemental Retirement Plan for Executive Employees of State Auto Insurance Companies	Form 10-Q Quarterly Report for the period ended June 30, 2008 (see Exhibit 10.01 therein)
10.86*	Amendment No. 2 effective as of January 1, 2009 to the Supplemental Retirement Plan for Executive Employees of State Auto Insurance Companies	Form 10-Q Quarterly Report for the period ended September 30, 2008 (see Exhibit 10.01 therein)
10.87*	Supplemental Retirement Plan for Executive Employees of State Auto Insurance Companies effective as of May 1, 2010	Form 10-Q Quarterly Report for the period ended June 30, 2010 (see Exhibit 10.01 therein)
10.88*	First Amendment to the Supplemental Retirement Plan for Executive Employees of State Auto Insurance Companies (amendment effective December 1, 2010)	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.96 therein)
10.89*	State Auto Financial Corporation Supplemental Executive Retirement Plan, effective January 1, 2007	Form 10-Q Quarterly Report for the period ended September 30, 2007 (see Exhibit 10.72 therein)
10.90*	First Amendment to the State Auto Financial Corporation Supplemental Executive Retirement Plan effective December 1, 2010	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 10.98 therein)
10.91*	Form of Designation of Distribution Election for the State Auto Financial Corporation Supplemental Executive Retirement Plan	Form 10-Q Quarterly Report for the period ended September 30, 2007 (see Exhibit 10.73 therein)
10.92*	State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan (amended and restated as of March 1, 2001)	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.58 therein)
10.93*	First Amendment to the State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan (amendment effective as of December 1, 2005)	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.59 therein)
10.94*	Second Amendment to the State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan (amendment effective as of January 1, 2009)	Form 10-Q Quarterly Report for the period ended September 30, 2008 (see Exhibit 10.02 therein)

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

Exhibit	No.	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.95*	Third Amendment to the State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan (amendment effective as of January 1, 2009)	Form 10-K Annual Report for the year ended December 31, 2008 (see Exhibit 10.84 therein)	
10.96*	Fourth Amendment to the State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan effective November 1, 2010	1933 Act Registration Statement No. 333-170564 on Form S-8 (see Exhibit 4(j) therein)	
10.97*	Fifth Amendment to the State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan effective January 1, 2012	Form 10-Q Quarterly Report for the period ended September 30, 2012 (see Exhibit 10.1 therein)	
10.98*	Agreement of Assignment and Assumption dated as of March 1, 2001, among State Auto Financial Corporation, State Automobile Mutual Insurance Company, State Auto Property and Casualty Insurance Company, and Midwest Security Insurance Company (nka State Auto Insurance Company of Wisconsin) regarding the State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.60 therein)	
10.99*	Form of State Auto Insurance Companies Directors Deferred Compensation Agreement	Form 10-K Annual Report for the year ended December 31, 2005 (see Exhibit 10.61 therein)	
10.100*	State Auto Property & Casualty Insurance Company Amended and Restated Incentive Deferred Compensation Plan effective as of March 1, 2010	1933 Act Registration Statement No. 333-165366 on Form S-8 (see Exhibit 4(e) therein)	
10.101*	First Amendment to the State Auto Property & Casualty Insurance Company Amended and Restated Incentive Deferred Compensation Plan (amendment effective July 1, 2010)	Form 10-Q Quarterly Report for the period ended June 30, 2010 (see Exhibit 10.02 therein)	
10.102*	Second Amendment to the State Auto Property & Casualty Insurance Company Amended and Restated Incentive Deferred Compensation Plan (amendment effective November 1, 2010)	1933 Act Registration Statement No. 333-170568 on Form S-8 (see Exhibit 4(h) therein)	
10.103*	Third Amendment to the State Auto Property & Casualty Insurance Company Amended and Restated Incentive Deferred Compensation Plan (amendment effective January 1, 2011)	Form 10-K Annual Report for year ended December 31, 2011 (see Exhibit 10.109 therein)	
10.104*	State Auto Financial Corporation Leadership Bonus Plan	Form 10-Q Quarterly Report for the period ended June 30, 2007 (see Exhibit 10.64 therein)	
10.105*	First Amendment to the State Auto Financial Corporation Leadership Bonus Plan (amendment effective as of January 1, 2009)	Form 10-Q Quarterly Report for the period ended September 30, 2008 (see Exhibit 10.04 therein)	
10.106*	Second Amendment to the State Auto Financial Corporation Leadership Bonus Plan (amendment effective as of January 1, 2012)	Form 8K Current Report filed on May 10, 2012 (see Exhibit 10.2 therein)	
10.107*	State Auto Financial Corporation Long-Term Incentive Plan	Form 10-Q Quarterly Report for the period ended June 30, 2007 (see Exhibit 10.65 therein)	
10.108*	First Amendment to the State Auto Financial Corporation Long-Term Incentive Plan (amendment effective as of January 1, 2008)	Form 8-K Current Report filed on March 13, 2008 (see Exhibit 10.5 therein)	

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

Exhibit		
No.	Description of Exhibit	If incorporated by reference document with which Exhibit was previously filed with SEC
10.109*	Second Amendment to the State Auto Financial Corporation Long-Term Incentive Plan (amendment effective as of January 1, 2009)	Form 10-Q Quarterly Report for the period ended September 30, 2008 (see Exhibit 10.05 therein)
10.110*	Third Amendment to the State Auto Financial Corporation Long-Term Incentive Plan (amendment effective as of January 1, 2012)	Form 8-K Current Report filed on May 10, 2012 (see Exhibit 10.3 therein)
10.111*	Underwriting Management Agreement effective as of November 20, 2009, by and between Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company, Bloomington Compensation Insurance Company, State Automobile Mutual Insurance Company, State Auto Property & Casualty Insurance Company, Meridian Security Insurance Company, Milbank Insurance Company, Farmers Casualty Insurance Company, and Risk Evaluation and Design, LLC	Form 8-K Current Report filed on November 25, 2009 (see Exhibit 10.1 therein)
21.01	List of Subsidiaries of State Auto Financial Corporation	Included herein
23.01	Consent of Independent Registered Public Accounting Firm	Included herein
24.01	Powers of Attorney Robert P. Restrepo, Jr., David J. D. Antoni, David R. Meuse, S. Elaine Roberts, Alexander B. Trevor and Paul S. Williams	Form 10-K Annual Report for the year ended December 31, 2007 (see Exhibit 24.01 therein)
24.02	Powers of Attorney Robert E. Baker and Thomas E. Markert	Form 10-Q Quarterly Report for the period ended March 31, 2008 (see Exhibit 24.01 therein)
24.03	Power of Attorney Eileen A. Mallesch	Form 10-K Annual Report for year ended December 31, 2010 (see Exhibit 24.03 therein)
31.01	CEO certification required by Section 302 of Sarbanes-Oxley Act of 2002	Included herein
31.02	CFO certification required by Section 302 of Sarbanes-Oxley Act of 2002	Included herein
32.01	CEO certification required by Section 906 of Sarbanes-Oxley Act of 2002	Included herein
32.02	CFO certification required by Section 906 of Sarbanes-Oxley Act of 2002	Included herein
101.INS**	XBRL Instance Document	Included herein
101.SCH**	XBRL Taxonomy Extension Schema Document	Included herein
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document	Included herein
101.DEF**	XBRL Taxonomy Definition Linkbase Document	Included herein
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document	Included herein
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document	Included herein

\* Constitutes either a management contract or a compensatory plan or arrangement required to be filed as an Exhibit.

\*\* The XBRL related information in Exhibit 101 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

(b) EXHIBITS

The exhibits included with this Form 10-K, as indicated in Item 15(a)(3), have been separately filed.

(c) FINANCIAL STATEMENT SCHEDULES

Our financial statement schedules included with this Form 10-K, as indicated in Item 15(a)(2), follow the signatures to this Form 10-K.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

STATE AUTO FINANCIAL CORPORATION

Dated: March 8, 2013

/s/ ROBERT P. RESTREPO, JR.  
**Robert P. Restrepo, Jr.**

**Chairman, President and Chief Executive Officer**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ ROBERT P. RESTREPO, JR. <b>Robert P. Restrepo, Jr.</b>	Chairman, President and Chief Executive Officer (principal executive officer)	March 8, 2013
/s/ STEVEN E. ENGLISH <b>Steven E. English</b>	Vice President and Chief Financial Officer (principal financial officer)	March 8, 2013
/s/ PETER J. LOVE <b>Peter J. Love</b>	Controller (principal accounting officer)	March 8, 2013
DAVID J. D. ANTONI* <b>David J. D. Antoni</b>	Director	March 8, 2013
ROBERT E. BAKER* <b>Robert E. Baker</b>	Director	March 8, 2013
THOMAS E. MARKERT* <b>Thomas E. Markert</b>	Director	March 8, 2013
DAVID R. MEUSE* <b>David R. Meuse</b>	Director	March 8, 2013
S. ELAINE ROBERTS* <b>S. Elaine Roberts</b>	Director	March 8, 2013
EILEEN A. MALLESCH* <b>Eileen A. Mallesch</b>	Director	March 8, 2013
ALEXANDER B. TREVOR* <b>Alexander B. Trevor</b>	Director	March 8, 2013

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

**Alexander B. Trevor**

PAUL S. WILLIAMS\*

Director

March 8, 2013

**Paul S. Williams**

\* Steven E. English by signing his name hereto, does sign this document on behalf of the person indicated above pursuant to a Power of Attorney duly executed by such person.

/s/ STEVEN E. ENGLISH

Attorney in Fact

March 8, 2013

**Steven E. English**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

## SCHEDULE I SUMMARY OF INVESTMENTS - OTHER THAN

## INVESTMENTS IN RELATED PARTIES

DECEMBER 31, 2012

(\$ millions)

	Cost or amortized cost <sup>(1)</sup>	Fair value	Amount at which shown in the balance sheet
<b>At December 31, 2012:</b>			
Available-for-sale:			
Fixed maturities:			
U.S. treasury securities and obligations of U.S. government agencies	\$ 328.2	366.5	366.5
Obligations of states and political subdivisions	750.4	800.3	800.3
Corporate securities	320.5	338.6	338.6
U.S. government agencies residential mortgage-backed securities	377.1	399.7	399.7
<i>Total fixed maturities</i>	<b>1,776.2</b>	<b>1,905.1</b>	<b>1,905.1</b>
Equity securities:			
Large-cap securities	152.6	174.2	174.2
Small-cap securities	43.6	54.2	54.2
<i>Total equity securities</i>	<b>196.2</b>	<b>228.4</b>	<b>228.4</b>
Other invested assets	49.0	64.4	64.4
<i>Total available-for-sale securities</i>	<b>2,021.4</b>	<b>2,197.9</b>	<b>2,197.9</b>
Other invested assets	0.5	0.5	0.5
<i>Total investments other than investments in related parties</i>	<b>\$ 2,021.9</b>	<b>2,198.4</b>	<b>2,198.4</b>

<sup>(1)</sup> Original cost of equity securities and, as to fixed maturities, original cost reduced by repayments and adjusted for amortization of premiums or accrual of discounts.



## STATE AUTO FINANCIAL CORPORATION

## SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

## Condensed Balance Sheets

(in millions, except per share amounts)

	December 31	
	2012	2011 As adjusted
<b>Assets</b>		
Investments in common stock of subsidiaries (equity method)	\$ 834.9	\$ 826.4
Fixed maturities, available-for-sale, at fair value	5.9	3.0
Equity securities, available-for-sale, at fair value	3.2	
Other invested assets	2.1	1.9
Cash and cash equivalents	7.0	8.4
Other assets	1.6	2.1
Due from affiliates	1.8	2.2
Federal income tax, net	1.3	0.3
<b>Total assets</b>	<b>\$ 857.8</b>	<b>\$ 844.3</b>
<b>Liabilities and Stockholders' Equity</b>		
Notes payable (affiliates \$15.5 and \$15.5, respectively)	\$ 115.9	\$ 116.4
Other liabilities	4.7	4.1
<b>Total liabilities</b>	<b>120.6</b>	<b>120.5</b>
Stockholders' equity:		
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; 47.3 and 47.1 issued, respectively, at stated value of \$2.50 per share	118.1	117.8
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	(115.8)	(115.8)
Additional paid-in capital	131.6	127.3
Accumulated other comprehensive income	84.2	63.8
Retained earnings	519.1	530.7
<b>Total stockholders' equity</b>	<b>737.2</b>	<b>723.8</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 857.8</b>	<b>\$ 844.3</b>

See accompanying note to condensed financial statements.

## STATE AUTO FINANCIAL CORPORATION

## SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

## CONTINUED

## Condensed Statements of Income

(\$ millions)	Year ended December 31		
	2012	2011 As adjusted	2010 As adjusted
Net investment income	\$ 0.2	0.6	0.5
Net realized gain on investments	0.4	0.7	4.3
<b>Total revenues</b>	<b>0.6</b>	<b>1.3</b>	<b>4.8</b>
Interest expense (affiliates \$0.7, \$0.7 and \$0.7, respectively)	7.0	7.1	7.1
Other operating expenses	5.8	4.2	5.5
<b>Total expenses</b>	<b>12.8</b>	<b>11.3</b>	<b>12.6</b>
<b>Loss before federal income taxes</b>	<b>(12.2)</b>	<b>(10.0)</b>	<b>(7.8)</b>
Federal income tax (benefit) expense	(1.7)	8.6	(4.0)
<b>Net loss before equity in net income (loss) of subsidiaries</b>	<b>(10.5)</b>	<b>(18.6)</b>	<b>(3.8)</b>
Equity in net income (loss) of subsidiaries	21.2	(142.1)	28.2
<b>Net income (loss)</b>	<b>\$ 10.7</b>	<b>(160.7)</b>	<b>24.4</b>

See accompanying note to condensed financial statements.

## STATE AUTO FINANCIAL CORPORATION

## SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

## CONTINUED

## Condensed Statements of Comprehensive Income (Loss)

(\$ millions, except per share amounts)

	Year ended December 31		
	2012	2011 As adjusted	2010 As adjusted
Net income (loss)	\$ 10.7	(160.7)	24.4
Other comprehensive income, net of tax:			
Net unrealized holding gains on investments:			
Unrealized holding gain arising during the year	0.7	(0.1)	1.1
Reclassification adjustments for gains realized in net income	0.4	0.7	0.5
Income tax expense (benefit)		0.3	(0.2)
<i>Total net unrealized holding gains on investments</i>	<b>1.1</b>	0.9	1.4
Unrealized equity in subsidiaries	<b>19.3</b>	70.8	(6.4)
<i>Other comprehensive income (loss)</i>	<b>20.4</b>	71.7	(5.0)
<b>Comprehensive income (loss)</b>	<b>\$ 31.1</b>	(89.0)	19.4

See accompanying note to condensed financial statements.

## STATE AUTO FINANCIAL CORPORATION

## SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

## CONTINUED

## Condensed Statements of Cash Flows

(\$ millions)	Year ended December 31		
	2012	2011 As adjusted	2010 As adjusted
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ 10.7	(160.7)	24.4
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation and amortization, net	(0.3)	(0.6)	(0.1)
Share-based compensation	0.4	0.1	0.3
Net realized gain on investments	(0.4)	(0.7)	(4.3)
Equity in net (income) loss from consolidated subsidiaries	(21.2)	142.1	(28.2)
Changes in operating assets and liabilities:			
Other liabilities and due from affiliates	1.5	0.4	1.0
Other assets	0.2	0.1	0.1
Excess tax benefits on share-based awards			0.3
Federal income taxes, net	(1.2)	10.6	(0.6)
<b>Net cash used in operating activities</b>	<b>(10.3)</b>	<b>(8.7)</b>	<b>(7.1)</b>
<b>Cash flows from investing activities:</b>			
Capitalization of subsidiary			0.1
Dividends received from consolidated subsidiaries	27.0	6.5	9.0
Purchases of equity securities available-for-sale	(3.2)		
Purchases of other invested assets	(0.3)	(0.2)	(0.3)
Maturities, calls and pay downs of fixed maturities available-for-sale	2.5	1.0	9.2
Sales of fixed maturities available-for-sale	0.3	13.8	4.1
Sales of equity securities available-for-sale	3.2		
Sale of subsidiary		13.2	(0.1)
<b>Net cash provided by investing activities</b>	<b>29.5</b>	<b>34.3</b>	<b>22.0</b>
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of common stock	1.6	2.6	3.2
Payment of dividends	(22.2)	(24.1)	(24.0)
<b>Net cash used in financing activities</b>	<b>(20.6)</b>	<b>(21.5)</b>	<b>(20.8)</b>
<i>Net (decrease) increase in cash and cash equivalents</i>	<b>(1.4)</b>	4.1	(5.9)
Cash and cash equivalents at beginning of year	8.4	4.3	10.2
<b>Cash and cash equivalents at end of year</b>	<b>\$ 7.0</b>	8.4	4.3
<i>Supplemental Disclosures:</i>			
Federal income tax benefit received	\$ 12.4	2.3	3.7
Interest paid (affiliates \$0.7, \$0.7 and \$0.7, respectively)	\$ 7.0	7.0	7.0

See accompanying note to condensed financial statements.

## STATE AUTO FINANCIAL CORPORATION

## SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

## CONTINUED

## Note to Condensed Financial Statements

STFC's investment in subsidiaries is stated at cost plus equity in net income (loss) from consolidated subsidiaries since the date of acquisition. STFC's share of net income (loss) of its unconsolidated subsidiaries is included in consolidated income (loss) using the equity method.

During 2012 State Auto Financial received dividends from Stateco in the amount of \$9.2 million in investments. In 2010, State Auto Financial received dividends from SA National in the amount of \$56.4 million in cash and fixed maturity securities and contributed \$21.0 million in fixed maturity securities to State Auto P&C. On December 31, 2010, State Auto Financial sold SA National and realized a net gain of \$3.9 million.

These financial statements should be read in conjunction with the consolidated financial statements of State Auto Financial Corporation.

In October 2010, the Financial Accounting Standards Board 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 Company adopted this guidance, with retrospective application, at January 1, 2012. The cumulative effect of this retrospective adoption of this guidance reduced stockholders equity by \$20.5 million, after-tax, at January 1, 2010. Previously reported financial information in State Auto Financial's condensed balance has been revised to reflect the effect of State Auto Financial's adoption of this accounting standard. This adoption did not have any impact on cash flows from operating activities on the condensed statements of cash flows.

State Auto Financial has also corrected the condensed balance sheet as of December 31, 2011 for an immaterial misstatement, which resulted in an increase in Investments in common stock of subsidiaries (equity method) and Retained earnings by \$13.3 million, respectively. The correction of this error did not impact the consolidated statements of income, comprehensive income and cash flows of the Company for any periods presented.

The following table sets forth the effect of the adoption of the deferred acquisition cost accounting standard and the correction of the immaterial misstatement on State Auto Financial Corporation's condensed balance sheet as of December 31, 2011 were as follows:

	December 31, 2011		
	Investments in common stock of subsidiaries (equity method)	Retained earnings	Stockholders equity
(\$ in millions)			
As previously reported	\$ 847.6	\$ 551.9	\$ 745.0
Cumulative effect of adoption of accounting standard	(34.5)	(34.5)	(34.5)
Correction of immaterial misstatement	13.3	13.3	13.3
As adjusted	\$ 826.4	\$ 530.7	\$ 723.8

The effect the adoption of the deferred acquisition cost accounting standard on State Auto Financial's condensed income and comprehensive (loss) income statements for the years ended December 31, 2011 and 2010 was as follows:

	December 31, 2011		
	Equity in	Net loss	Comprehensive loss
(\$ in millions)			

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

	<b>net loss of subsidiaries</b>		
As previously reported	\$ (128.2)	\$ (146.8)	\$ (75.1)
Cumulative effect of adoption of accounting standard	(13.9)	(13.9)	(13.9)
As adjusted	\$ (142.1)	\$ (160.7)	\$ (89.0)

	<b>December 31, 2010</b>		
	<b>Equity in net income of subsidiaries</b>	<b>Net income</b>	<b>Comprehensive loss</b>
<i>(\$ in millions)</i>			
As previously reported	\$ 28.3	\$ 24.5	\$ 19.5
Cumulative effect of adoption of accounting standard	(0.1)	(0.1)	(0.1)
As adjusted	\$ 28.2	\$ 24.4	\$ 19.4

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

## SCHEDULE III SUPPLEMENTARY INSURANCE INFORMATION

Years Ended December 31, 2012, 2011 and 2010

(\$ millions)

Segment	Deferred policy acquisition cost	Future benefits, claims and losses <sup>(1)</sup>	Unearned premiums	Other policy claims and benefits payable	Premium revenue
<b>Year ended December 31, 2012:</b>					
Personal insurance segment	\$ 30.1	231.0	188.4		469.8
Business insurance segment	35.0	341.8	180.9		327.2
Specialty insurance segment	26.6	355.9	112.3		245.1
Investment operations segment					
Total	\$ 91.7	928.7	481.6		1,042.1
<b>Year ended December 31, 2011:</b>					
Personal insurance segment	\$ 30.5	279.0	188.7		800.6
Business insurance segment	28.5	336.9	161.3		379.0
Specialty insurance segment	32.7	265.7	120.2		249.2
Investment operations segment					
Total	\$ 91.7	881.6	470.2		1,428.8
<b>Year ended December 31, 2010:</b>					
Personal insurance segment	\$ 59.7	341.2	342.1		798.5
Business insurance segment	35.4	410.9	197.6		383.5
Specialty insurance segment	23.4	122.1	73.5		75.2
Investment operations segment					
Total	\$ 118.5	874.2	613.2		1,257.2

Segment	Net investment income	Benefits, losses and settlement expenses <sup>(2)</sup>	Amort. of deferred policy acquisition costs	Other operating expenses	Premiums written
<b>Year ended December 31, 2012:</b>					
Personal insurance segment	\$	344.8	76.6	46.6	469.5
Business insurance segment		222.5	63.1	80.6	349.4
Specialty insurance segment		211.7	73.4	5.6	236.4
Investment operations segment	75.4				
Total	\$ 75.4	779.0	213.1	132.8	1,055.3

Year ended December 31, 2011:

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

Personal insurance segment	\$	698.9	133.4	54.7	647.4
Business insurance segment		296.4	67.5	103.3	341.7
Specialty insurance segment		182.4	73.5	52.6	295.5
Investment operations segment		85.4			
Total	\$	85.4	1,177.7	274.4	210.6
Year ended December 31, 2010:					
Personal insurance segment	\$	569.4	134.2	98.0	819.9
Business insurance segment		260.7	71.5	71.5	377.3
Specialty insurance segment		53.1	8.1	41.2	126.3
Investment operations segment		80.8			
Total	\$	80.8	883.2	213.8	210.7

(1) Segmented balances are net of reinsurance recoverable on losses and loss expenses payable.

(2) Benefits, losses and settlement expenses are monitored on a statutory basis.



## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

## SCHEDULE IV REINSURANCE

Years Ended December 31, 2012, 2011 and 2010

(\$ million, except percentages)

	Ceded to			Assumed from		Net Amount	Percentage of amount assumed to net <sup>(2)</sup>
	Gross Amount	Unaffiliated Companies	Affiliated Companies <sup>(1)</sup>	Unaffiliated Companies	Affiliated Companies <sup>(1)</sup>		
Property-casualty earned premiums for year ended December 31,							
<b>2012</b>	<b>\$ 833.3</b>	<b>\$ 28.2</b>	<b>\$ 809.2</b>	<b>\$ 4.1</b>	<b>\$ 1,042.1</b>	<b>\$ 1,042.1</b>	<b>0.4%</b>
2011	812.1	26.7	803.6	18.2	1,428.8	1,428.8	1.3%
2010	842.1	26.8	818.8	3.5	1,257.2	1,257.2	0.3%

<sup>(1)</sup> These columns include the effect of intercompany pooling.<sup>(2)</sup> Calculated as earned premiums assumed from outside companies to net amount.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

SCHEDULE V VALUATION AND QUALIFYING ACCOUNTS

Years Ended December 31, 2012, 2011 and 2010

(\$ millions)

		At December 31	
	2012	2011 As adjusted	2010 As adjusted
<b>Valuation allowance for deferred tax assets:</b>			
Balance at beginning of period	\$ 103.3		
Additions		103.3	
Deductions	2.8		
Balance at end of period	\$ 100.5	103.3	