

State Auto Financial CORP
Form 10-Q
May 09, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

or

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

Commission File Number 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

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

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

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes No

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

(\$ millions, except per share amount)

	March 31	December 31
	2012	2011
	(unaudited)	As adjusted (see note 1)
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,787.1 and \$1,817.3, respectively)	\$ 1,904.1	1,934.9
Equity securities, available-for-sale, at fair value (cost \$142.7 and \$141.7, respectively)	179.9	167.3
Other invested assets, available-for-sale, at fair value (cost \$48.9 and \$48.6, respectively)	61.5	57.2
Other invested assets	0.5	0.5
Notes receivable from affiliate	70.0	70.0
<i>Total investments</i>	2,216.0	2,229.9
Cash and cash equivalents	63.0	356.0
Accrued investment income and other assets	30.9	30.2
Deferred policy acquisition costs	94.2	91.7
Reinsurance recoverable on losses and loss expenses payable (affiliates none)	27.0	25.5
Prepaid reinsurance premiums (affiliates none)	8.5	7.9
Current federal income taxes	12.3	12.3
Net deferred federal income taxes	0.6	0.5
Property and equipment, at cost	10.3	10.4
<i>Total assets</i>	\$ 2,462.8	2,764.4
Liabilities and Stockholders Equity		
Losses and loss expenses payable (affiliates \$368.6 and \$376.8, respectively)	\$ 920.2	907.1
Unearned premiums (affiliates \$108.3 and \$98.4, respectively)	479.3	470.2
Notes payable (affiliates \$15.5 and \$15.5, respectively)	116.3	116.4
Postretirement and pension benefits	111.1	112.8
Due to affiliate	2.0	349.4
Other liabilities	101.6	84.7
<i>Total liabilities</i>	1,730.5	2,040.6
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		

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

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

(\$ millions, except per share amounts)

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

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income

(\$ millions, except per share amounts)

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Cash Flows

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

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

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

1. Basis of Presentation

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

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

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

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

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

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

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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

(\$ in millions, except per share amounts)

Three Months Ended March 31, 2011

As

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

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

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

Testing Goodwill for Impairment

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

2. Investments

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

(\$ millions)

At March 31, 2012:

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

(\$ millions)

At December 31, 2011:

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

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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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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

(\$ millions, except # of positions)

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

(\$ 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
At December 31, 2011:									
Fixed maturities:									
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

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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

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

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

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

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

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

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

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

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

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

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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

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

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

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

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

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

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

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3. Fair Value of Financial Instruments

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

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

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

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

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

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

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

Fixed Maturities

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

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

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Equities

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

Other Invested Assets

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

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

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

(\$ millions)

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

(\$ 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:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 468.7		468.7	
Obligations of states and political subdivisions	811.2		811.2	
Corporate securities	244.8		241.9	2.9
	410.2		410.2	

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U.S. government agencies residential mortgage-backed securities

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

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

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

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

Notes Receivable from Affiliates

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

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

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(\$ millions, except interest rates)

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

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Notes Payable

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

(\$ millions, except interest rates)

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

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

(\$ millions)

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

4. Reinsurance

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

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

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

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

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

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

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

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

5. Income Taxes

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

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

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

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