

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)**

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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.



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**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.

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**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.





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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.

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**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.

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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.

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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](#).

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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.

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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.

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	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

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## 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 and 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).

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**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

<sup>(1)</sup> Age as of March 8, 2013.

<sup>(2)</sup> 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.



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## 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;

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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

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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.*

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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.

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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

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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,

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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.

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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.



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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



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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

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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

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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



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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



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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.



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
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