

State Auto Financial CORP  
Form 10-Q  
August 05, 2015  
Table of Contents

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

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2015

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	31-1324304
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

518 East Broad Street, Columbus, Ohio	43215-3976
(Address of principal executive offices)	(Zip Code)

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

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 ý No ¨

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

Yes ý No ¨

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

Large accelerated filer ¨ Accelerated filer ý Non-accelerated filer ¨

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

Yes ¨ No ý

On July 31, 2015, the Registrant had 41,223,677 Common Shares outstanding.

Table of Contents

Index to Form 10-Q Quarterly Report for the three and six month period ended June 30, 2015

Part I. Financial Information

Item 1.	<u>Financial Statements (Unaudited)</u>	
	<u>Condensed consolidated balance sheets – June 30, 2015 and December 31, 2014</u>	<u>1</u>
	<u>Condensed consolidated statements of income – Three months ended June 30, 2015 and 2014</u>	<u>2</u>
	<u>Condensed consolidated statements of income – Six months ended June 30, 2015 and 2014</u>	<u>3</u>
	<u>Condensed consolidated statements of comprehensive income – Three months ended June 30, 2015 and 2014</u>	<u>4</u>
	<u>Condensed consolidated statements of comprehensive income – Six months ended June 30, 2015 and 2014</u>	<u>5</u>
	<u>Condensed consolidated statements of cash flows – Six months ended June 30, 2015 and 2014</u>	<u>6</u>
	<u>Notes to condensed consolidated financial statements – June 30, 2015</u>	<u>7</u>
Item 2.	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>25</u>
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>51</u>
Item 4.	<u>Controls and Procedures</u>	<u>52</u>

Part II. Other Information

Item 1.	<u>Legal Proceedings</u>	<u>53</u>
Item 1A.	<u>Risk Factors</u>	<u>53</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>53</u>
Item 4.	<u>Mine Safety Disclosures</u>	<u>53</u>
Item 5.	<u>Other Information</u>	<u>53</u>
Item 6.	<u>Exhibits</u>	<u>54</u>
	<u>Signatures</u>	<u>55</u>

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## PART I – FINANCIAL STATEMENTS

## Item 1. Condensed Consolidated Balance Sheets

(\$ and shares in millions, except per share amounts)	June 30, 2015 (unaudited)	December 31, 2014
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,927.1 and \$1,831.3, respectively)	\$ 1,959.1	\$ 1,891.9
Equity securities, available-for-sale, at fair value (cost \$230.0 and \$235.5, respectively)	297.4	310.4
Other invested assets, available-for-sale, at fair value (cost \$54.6 and \$50.5, respectively)	89.3	80.3
Other invested assets	5.3	5.3
Notes receivable from affiliate	70.0	70.0
Total investments	2,421.1	2,357.9
Cash and cash equivalents	50.6	86.3
Accrued investment income and other assets	35.0	33.8
Deferred policy acquisition costs (affiliated net assumed \$53.1 and \$46.8, respectively)	133.5	126.5
Reinsurance recoverable on losses and loss expenses payable	9.0	9.6
Prepaid reinsurance premiums	6.4	6.1
Due from affiliate	35.5	40.1
Current federal income taxes	3.0	1.1
Net deferred federal income taxes	98.7	97.4
Property and equipment, at cost	7.7	8.1
Total assets	\$ 2,800.5	\$ 2,766.9
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliated net assumed \$507.0 and \$494.3, respectively)	\$ 1,023.0	\$ 983.2
Unearned premiums (affiliated net assumed \$223.1 and \$201.7, respectively)	632.3	612.4
Notes payable (affiliates \$15.5 and \$15.5, respectively)	100.8	100.8
Postretirement and pension benefits (affiliated net ceded \$61.2 and \$63.2, respectively)	113.7	117.3
Other liabilities (affiliated net ceded \$3.4 and \$5.1, respectively)	53.2	80.3
Total liabilities	1,923.0	1,894.0
Stockholders' equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued	—	—
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued	—	—
Common stock, without par value. Authorized 100.0 shares; 47.9 and 47.7 shares issued, respectively, at stated value of \$2.50 per share	119.8	119.3
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	(116.2	) (116.0
Additional paid-in capital	146.7	143.2
Accumulated other comprehensive income (affiliated net ceded \$62.3 and \$65.1, respectively)	53.4	71.7
Retained earnings	673.8	654.7

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

Total stockholders' equity	877.5	872.9
Total liabilities and stockholders' equity	\$2,800.5	\$2,766.9

See accompanying notes to condensed consolidated financial statements.

1

---

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Condensed Consolidated Statements of Income

(\$ in millions, except per share amounts)

(unaudited)	Three months ended June 30	
	2015	2014
Earned premiums (affiliated net assumed \$102.9 and \$51.5, respectively)	\$311.5	\$268.3
Net investment income (affiliated \$1.2 and \$1.2, respectively)	19.8	20.5
Net realized gains on investments:		
Total other-than-temporary impairment losses	(0.8	) (0.3
Portion of loss recognized in other comprehensive income	—	—
Other net realized investment gains	6.2	5.6
Total net realized gains on investments	5.4	5.3
Other income from affiliates	0.7	0.3
Total revenues	337.4	294.4
Losses and loss expenses (affiliated net assumed \$59.4 and \$47.6, respectively)	224.6	190.4
Acquisition and operating expenses (affiliated net assumed \$58.8 and \$42.3, respectively)	105.9	97.3
Interest expense (affiliated \$0.2 and \$0.1, respectively)	1.4	1.3
Other expenses	2.1	2.3
Total expenses	334.0	291.3
Income before federal income taxes	3.4	3.1
Federal income tax expense:		
Current	0.2	0.1
Deferred	0.5	—
Total federal income tax expense	0.7	0.1
Net income	\$2.7	\$3.0
Earnings per common share:		
Basic	\$0.06	\$0.07
Diluted	\$0.06	\$0.07
Dividends paid per common share	\$0.10	\$0.10

See accompanying notes to condensed consolidated financial statements.

2

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Condensed Consolidated Statements of Income

(\$ in millions, except per share amounts)

(unaudited)	Six months ended June 30	
	2015	2014
Earned premiums (affiliated net assumed \$208.3 and \$98.6, respectively)	\$ 626.8	\$ 530.8
Net investment income (affiliate \$2.4 and \$2.4, respectively)	35.2	38.1
Net realized gains on investments:		
Total other-than-temporary impairment losses	(1.3	) (1.2
Portion of loss recognized in other comprehensive income	—	—
Other net realized investment gains	10.5	17.2
Total net realized gains on investments	9.2	16.0
Other income from affiliates	1.1	0.8
Total revenues	672.3	585.7
Losses and loss expenses (affiliated net assumed \$133.5 and \$78.0, respectively)	419.6	362.2
Acquisition and operating expenses (affiliated net assumed \$136.1 and \$81.2, respectively)	209.3	185.8
Interest expense (affiliates \$0.4 and \$0.3, respectively)	2.7	2.6
Other expenses	4.1	4.3
Total expenses	635.7	554.9
Income before federal income taxes	36.6	30.8
Federal income tax expense:		
Current	0.6	0.7
Deferred	8.6	—
Total federal income tax expense	9.2	0.7
Net income	\$ 27.4	\$ 30.1
Earnings per common share:		
Basic	\$ 0.67	\$ 0.74
Diluted	\$ 0.66	\$ 0.73
Dividends paid per common share	\$ 0.20	\$ 0.20

See accompanying notes to condensed consolidated financial statements.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income (\$ in millions, except per share amounts) (unaudited)	Three months ended June 30		
	2015	2014	
Net income	\$2.7	\$3.0	
Other comprehensive (loss) income, net of tax:			
Net unrealized holding (losses) gains on investments:			
Unrealized holding (losses) gains	(38.6	) 34.9	
Reclassification adjustments for gains realized in net income	(5.4	) (5.3	)
Income tax benefit (expense)	15.4	(3.5	)
Total net unrealized holding (losses) gains on investments	(28.6	) 26.1	
Net unrecognized benefit plan obligations:			
Net actuarial loss arising during period	—	(1.6	)
Reclassification adjustments for amortization to statements of income:			
Negative prior service cost	(1.4	) (1.4	)
Net actuarial loss	2.9	2.2	
Income tax expense	(0.5	) —	
Total net unrecognized benefit plan obligations	1.0	(0.8	)
Other comprehensive (loss) income	(27.6	) 25.3	
Comprehensive (loss) income	\$(24.9	) \$28.3	

See accompanying notes to condensed consolidated financial statements.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income (\$ in millions, except per share amounts) (unaudited)	Six months ended June 30	
	2015	2014
Net income	\$27.4	\$30.1
Other comprehensive (loss) income, net of tax:		
Net unrealized holding (losses) gains on investments:		
Unrealized holding (losses) gains	(21.6	) 57.9
Reclassification adjustments for gains realized in net income	(9.6	) (16.0
Income tax benefit (expense)	10.9	(7.7
Total net unrealized holding (losses) gains on investments	(20.3	) 34.2
Net unrecognized benefit plan obligations:		
Net actuarial loss arising during period	—	(1.6
Reclassification adjustments for amortization to statements of income:		
Negative prior service cost	(2.8	) (2.8
Net actuarial loss	5.8	3.8
Income tax expense	(1.0	) —
Total net unrecognized benefit plan obligations	2.0	(0.6
Other comprehensive (loss) income	(18.3	) 33.6
Comprehensive income	\$9.1	\$63.7

See accompanying notes to condensed consolidated financial statements.



Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Condensed Consolidated Statements of Cash Flows

(\$ in millions)

(unaudited)

## Cash flows from operating activities:

Net income

## Adjustments to reconcile net income to net cash provided by operating activities:

Depreciation and amortization, net

Share-based compensation

Net realized gains on investments

## Changes in operating assets and liabilities:

Deferred policy acquisition costs

Accrued investment income and other assets

Postretirement and pension benefits

Other liabilities and due to/from affiliates, net

Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums

Losses and loss expenses payable

Unearned premiums

Excess tax benefits on share-based awards

Federal income taxes

Cash provided from December 31, 2014 unearned premium transfer related to the homeowners quota share arrangement

Net cash provided by operating activities

## Cash flows from investing activities:

Purchases of fixed maturities available-for-sale

Purchases of equity securities available-for-sale

Purchases of other invested assets

Maturities, calls and pay downs of fixed maturities available-for-sale

Sales of fixed maturities available-for-sale

Sales of equity securities available-for-sale

Sales of other invested assets available-for-sale

Net additions of property and equipment

Net cash used in investing activities

## Cash flows from financing activities:

Proceeds from issuance of common stock

Payments to acquire treasury stock

Payment of dividends

Net cash used in financing activities

Net decrease in cash and cash equivalents

Cash and cash equivalents at beginning of period

Cash and cash equivalents at end of period

## Supplemental disclosures:

Interest paid (affiliates \$0.3 and \$0.3, respectively)

Federal income taxes paid

Six months ended June 30

2015

2014

\$27.4

\$30.1

7.3

4.4

2.4

2.4

(9.2

) (16.0

)

(7.0

) (10.2

)

(0.6

) 0.4

(1.6

) (2.7

)

(87.8

) (36.6

)

0.3

(0.2

)

39.8

2.9

19.9

30.5

0.1

—

7.8

(0.2

)

63.5

—

62.3

4.8

(317.9

) (226.7

)

(26.1

) (84.9

)

(4.3

) (0.9

)

147.5

138.3

68.9

101.8

39.8

64.8

0.3

0.3

(0.1

) —

(91.9

) (7.3

)

2.4

2.1

(0.2

) (0.1

)

(8.3

) (8.3

)

(6.1

) (6.3

)

(35.7

) (8.8

)

86.3

80.3

\$50.6

\$71.5

\$2.6

\$2.6

\$2.4

\$1.0

See accompanying notes to condensed consolidated financial statements.

6

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries (“State Auto Financial” or the “Company”) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month period ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. The balance sheet at December 31, 2014 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2014 (the “2014 Form 10-K”). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2014 Form 10-K.

Adoption of Accounting Pronouncements

Simplifying the Presentation of Debt Issuance Costs

In April 2015, the FASB issued updated guidance to clarify the required presentation of debt issuance costs. The amended guidance requires that debt issuance costs be presented in the balance sheet as a direct reduction from the carrying amount of the recognized debt liability, consistent with the treatment of debt discounts and amortization of debt issuance costs is to be reported as interest expense. The recognition and measurement guidance for debt issuance costs is not affected by the updated guidance. The guidance is effective for reporting periods beginning after December 15, 2015 and early adoption is permitted. The adoption of this guidance will not have any effect on the Company’s results of operations, financial position or liquidity.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

## 2. Investments

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at June 30, 2015 and December 31, 2014:

(\$ millions)

June 30, 2015	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$274.5	\$13.3	\$(2.7)	) \$285.1
Obligations of states and political subdivisions	844.5	17.5	(8.6)	) 853.4
Corporate securities	341.6	7.8	(3.7)	) 345.7
U.S. government agencies mortgage-backed securities	466.5	13.0	(4.6)	) 474.9
Total fixed maturities	1,927.1	51.6	(19.6)	) 1,959.1
Equity securities:				
Large-cap securities	177.2	48.9	(1.3)	) 224.8
Small-cap securities	52.8	19.8	—	) 72.6
Total equity securities	230.0	68.7	(1.3)	) 297.4
Other invested assets	54.6	34.7	—	) 89.3
Total available-for-sale securities	\$2,211.7	\$155.0	\$(20.9)	) \$2,345.8

(\$ millions)

December 31, 2014	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$296.7	\$14.1	\$(1.5)	) \$309.3
Obligations of states and political subdivisions	742.5	27.4	(0.4)	) 769.5
Corporate securities	333.4	10.2	(3.0)	) 340.6
U.S. government agencies mortgage-backed securities	458.7	15.6	(1.8)	) 472.5
Total fixed maturities	1,831.3	67.3	(6.7)	) 1,891.9
Equity securities:				
Large-cap securities	185.5	57.3	(0.6)	) 242.2
Small-cap securities	50.0	18.2	—	) 68.2
Total equity securities	235.5	75.5	(0.6)	) 310.4
Other invested assets	50.5	29.8	—	) 80.3
Total available-for-sale securities	\$2,117.3	\$172.6	\$(7.3)	) \$2,282.6

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's gross unrealized losses and fair value on its investments by lot, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at June 30, 2015 and December 31, 2014:

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
June 30, 2015									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$40.6	\$ (1.6 )	11	\$20.7	\$ (1.1 )	6	\$61.3	\$ (2.7 )	17
Obligations of states and political subdivisions	333.6	(8.5 )	60	6.7	(0.1 )	3	340.3	(8.6 )	63
Corporate securities	77.0	(2.3 )	12	49.8	(1.4 )	9	126.8	(3.7 )	21
U.S. government agencies mortgage-backed securities	109.5	(3.8 )	17	34.7	(0.8 )	12	144.2	(4.6 )	29
Total fixed maturities	560.7	(16.2 )	100	111.9	(3.4 )	30	672.6	(19.6 )	130
Large-cap equity securities	9.0	(1.3 )	3	—	—	—	9.0	(1.3 )	3
Total temporarily impaired securities	\$569.7	\$ (17.5 )	103	\$111.9	\$ (3.4 )	30	\$681.6	\$ (20.9 )	133

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
December 31, 2014									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$19.9	\$ (0.3 )	4	\$52.0	\$ (1.2 )	17	\$71.9	\$ (1.5 )	21
Obligations of states and political subdivisions	6.1	—	5	30.9	(0.4 )	9	37.0	(0.4 )	14
Corporate securities	43.5	(0.9 )	8	56.1	(2.1 )	11	99.6	(3.0 )	19
U.S. government agencies mortgage-backed securities	44.0	(0.3 )	8	37.5	(1.5 )	13	81.5	(1.8 )	21
Total fixed maturities	113.5	(1.5 )	25	176.5	(5.2 )	50	290.0	(6.7 )	75
Large-cap equity securities	7.2	(0.6 )	2	—	—	—	7.2	(0.6 )	2
Total temporarily impaired securities	\$120.7	\$ (2.1 )	27	\$176.5	\$ (5.2 )	50	\$297.2	\$ (7.3 )	77

The Company reviewed its investments at June 30, 2015, and determined that no additional other-than-temporary impairment existed in the gross unrealized holding losses other than those listed in the table below. The following table sets forth the realized losses related to other-than-temporary impairments on the Company's investment portfolio recognized for the three and six months ended June 30, 2015 and 2014:

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

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Equity securities:				
Large-cap securities	\$—	\$—	\$—	\$(0.3)
Small-cap securities	(0.8)	) (0.3)	) (1.3)	) (0.9)
Total other-than-temporary impairments	\$ (0.8)	) \$ (0.3)	) \$ (1.3)	) \$ (1.2)

9

---

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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

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

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at June 30, 2015:

(\$ millions)	Amortized cost	Fair value
Due in 1 year or less	\$ 35.3	\$ 35.9
Due after 1 year through 5 years	355.2	367.0
Due after 5 years through 10 years	304.3	313.4
Due after 10 years	765.8	767.9
U.S. government agencies mortgage-backed securities	466.5	474.9
Total	\$ 1,927.1	\$ 1,959.1

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

At June 30, 2015, State Auto P&C had U.S. government agencies mortgage-backed fixed maturity securities, with a carrying value of approximately \$85.0 million, that were pledged as collateral for the Federal Home Loan Bank of Cincinnati ("FHLB") Loan. In accordance with the terms of the FHLB Loan, State Auto P&C retains all rights regarding these securities.

Fixed maturities with fair values of \$8.9 million and \$8.8 million were on deposit with insurance regulators as required by law at June 30, 2015 and December 31, 2014, respectively. The Company retains all rights regarding these securities.

The following table sets forth the components of net investment income for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Fixed maturities	\$ 17.4	\$ 17.9	\$ 30.3	\$ 33.3

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

Equity securities	1.7	1.7	3.3	3.1
Cash and cash equivalents, and other	1.3	1.4	2.7	2.7
Investment income	20.4	21.0	36.3	39.1
Investment expenses	0.6	0.5	1.1	1.0
Net investment income	\$ 19.8	\$ 20.5	\$ 35.2	\$ 38.1

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

10

---



Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Proceeds on sales of available-for-sale securities were \$109.0 million and \$166.9 million for the six months ended June 30, 2015 and 2014.

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30		
	2015	2014	2015	2014	
Realized gains:					
Fixed maturities	\$0.4	\$0.4	\$1.5	\$2.5	
Equity securities	5.9	5.2	10.0	14.7	
Other invested assets	0.1	—	0.1	0.1	
Total realized gains	6.4	5.6	11.6	17.3	
Realized losses:					
Equity securities:					
Sales	(0.2	) —	(0.7	) (0.1	)
OTTI	(0.8	) (0.3	) (1.3	) (1.2	)
Total realized losses	(1.0	) (0.3	) (2.0	) (1.3	)
Net realized gains on investments	\$5.4	\$5.3	\$9.6	\$16.0	
Change in unrealized holding gains, net of tax:					
Fixed maturities	\$(38.0	) \$19.6	\$(28.6	) \$34.0	
Equity securities	(6.5	) 6.2	(7.5	) 1.7	
Other invested assets	0.5	3.8	4.9	6.2	
Deferred federal income tax liability	15.4	(10.3	) 10.9	(14.6	)
Valuation allowance	—	6.8	—	6.9	
Change in net unrealized holding gains, net of tax	\$(28.6	) \$26.1	\$(20.3	) \$34.2	

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

3. Fair Value of Financial Instruments

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

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

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

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

The Company utilizes one nationally recognized pricing service to estimate the majority of its available-for-sale investment portfolio's fair value. The Company obtains one price per security and the processes and control procedures employed by the Company are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company gains an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, the Company compares to other fair value pricing information gathered from other independent pricing sources. At June 30, 2015 and December 31, 2014, the Company did not adjust any of the prices received from the pricing service.

Transfers between level categorizations may occur due to changes in the availability of market observable inputs.

Transfers in and out of level categorizations are reported as having occurred at the beginning of the quarter in which the transfer occurred. There were no transfers between level categorizations during the three and six months ended June 30, 2015 and 2014.

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

Fixed Maturities

The Company utilizes a third party pricing service to estimate fair value measurements for the majority of its fixed maturities. The fair value estimate of the Company's fixed maturity investments are determined by evaluations that are based on observable market information rather than market quotes. Inputs to the evaluations include, but are not limited to, market prices from recently completed transactions and transactions of comparable securities, interest rate yield curves, credit spreads, and other market-observable information. The fixed maturity portfolio pricing obtained from the pricing service is reviewed for reasonableness. The Company regularly selects a random sample of security prices which are compared to one or more alternative pricing sources for reasonableness. Any discrepancies with the pricing are returned to the pricing service for further explanation and, if necessary, adjustments are made. To date, the Company has not identified any significant discrepancies in the pricing provided by its third party pricing service.

Investments valued using these inputs include U.S. treasury securities and obligations of U.S. government agencies, obligations of states and political subdivisions, corporate securities (except for a security discussed below), and U.S. government agencies mortgage-backed securities. All unadjusted estimates of fair value for fixed maturities priced by the pricing service are included in the amounts disclosed in Level 2 of the hierarchy. If market inputs are unavailable, then no fair value is provided by the pricing service. For these securities, fair value is determined either by requesting brokers who are knowledgeable about these securities to provide a quote; or the Company internally determines the fair values by employing widely accepted pricing valuation models, and depending on the level of observable market inputs, renders the fair value estimate as Level 2 or Level 3. The Company holds one fixed maturity corporate security included in Level 3 and estimates its fair value using the present value of the future cash flows. Due to the limited amount of observable market information for this security, the Company includes the fair value estimate in Level 3.



Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Equities

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

Other Invested Assets

Included in other invested assets are two international funds (“the funds”) that invest in equity securities of foreign issuers and are managed by third party investment managers. The funds had a fair value of \$81.1 million and \$72.9 million at June 30, 2015 and December 31, 2014, respectively, which was determined using each fund’s net asset value. The Company employs procedures to assess the reasonableness of the fair value of the funds including obtaining and reviewing each fund’s audited financial statements. There are no unfunded commitments related to the funds. The Company may not sell its investment in the funds; however, the Company may redeem all or a portion of its investment in the funds at net asset value per share with the appropriate prior written notice. Due to the Company’s ability to redeem its investment in the funds at net asset value per share at the measurement date, the funds have been disclosed in Level 2.

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

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's available-for-sale investments within the fair value hierarchy at June 30, 2015 and December 31, 2014:

(\$ millions)	Total	Level 1	Level 2	Level 3
June 30, 2015				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 285.1	\$—	\$ 285.1	\$—
Obligations of states and political subdivisions	853.4	—	853.4	—
Corporate securities	345.7	—	342.2	3.5
U.S. government agencies mortgage-backed securities	474.9	—	474.9	—
Total fixed maturities	1,959.1	—	1,955.6	3.5
Equity securities:				
Large-cap securities	224.8	224.8	—	—
Small-cap securities	72.6	72.6	—	—
Total equity securities	297.4	297.4	—	—
Other invested assets	89.3	8.2	81.1	—
Total available-for-sale investments	\$2,345.8	\$ 305.6	\$ 2,036.7	\$ 3.5

(\$ millions)	Total	Level 1	Level 2	Level 3
December 31, 2014				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 309.3	\$—	\$ 309.3	\$—
Obligations of states and political subdivisions	769.5	—	769.5	—
Corporate securities	340.6	—	331.2	9.4
U.S. government agencies mortgage-backed securities	472.5	—	472.5	—
Total fixed maturities	1,891.9	—	1,882.5	9.4
Equity securities:				
Large-cap securities	242.2	242.2	—	—
Small-cap securities	68.2	68.2	—	—
Total equity securities	310.4	310.4	—	—
Other invested assets	80.3	7.4	72.9	—
Total available-for-sale investments	\$2,282.6	\$ 317.8	\$ 1,955.4	\$ 9.4

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), the following tables set forth a reconciliation of the beginning and ending balances for the three and six months ended June 30, 2015 and the year ended December 31, 2014, separately for each major category of assets:

(\$ millions)	Fixed maturities	
Balance at January 1, 2015	\$9.4	
Total realized gains – included in earnings	0.2	
Total unrealized losses – included in other comprehensive income	(0.2	)
Purchases	—	
Sales	(5.9	)
Transfers into Level 3	—	
Transfers out of Level 3	—	
Balance at March 31, 2015	\$3.5	
Total realized gains – included in earnings	—	
Total unrealized losses – included in other comprehensive income	(0.1	)
Purchases	0.1	
Sales	—	
Transfers into Level 3	—	
Transfers out of Level 3	—	
Balance at June 30, 2015	\$3.5	

(\$ millions)	Fixed maturities
Balance at January 1, 2014	\$8.9
Total realized gains – included in earnings	—
Total unrealized gains – included in other comprehensive income	0.2
Purchases	0.3
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at December 31, 2014	\$9.4

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

## Financial Instruments Disclosed, But Not Carried, At Fair Value

## Other Invested Assets

Included in other invested assets are common stock of the Federal Home Loan Bank of Cincinnati ("FHLB") and the Trust Securities. The Trust Securities and FHLB common stock are carried at cost, which approximates fair value. The fair value of the FHLB common stock at June 30, 2015 was \$4.8 million and the fair value of the Trust Securities was \$0.5 million. The investments have been placed in Level 3 of the fair value hierarchy.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

## Notes Receivable from Affiliate

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

(\$ millions, except interest rates)	June 30, 2015			December 31, 2014			
	Carrying value	Fair value	Interest rate	Carrying value	Fair value	Interest rate	
Notes receivable from affiliate	\$ 70.0	\$ 74.7	7.00	% \$ 70.0	\$ 74.6	7.00	%

## Notes Payable

Included in notes payable are the FHLB Loan and Subordinated Debentures. The Company estimates the fair value of the FHLB Loan by discounting cash flows using a borrowing rate currently available to the Company for a loan with similar terms. This has been placed in Level 3 of the fair value hierarchy. The carrying amount of the Subordinated Debentures approximates its fair value as the interest rate adjusts quarterly and has been disclosed in Level 3.

(\$ millions, except interest rates)	June 30, 2015			December 31, 2014			
	Carrying value	Fair Value	Interest rate	Carrying value	Fair value	Interest rate	
FHLB Loan due 2033: issued \$85.0, July 2013 with fixed interest	\$ 85.3	\$ 85.9	5.03	% \$ 85.3	\$ 86.4	5.03	%
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.5	15.5	4.48	% 15.5	15.5	4.44	%
Total notes payable	\$ 100.8	\$ 101.4		\$ 100.8	\$ 101.9		

## 4. Reinsurance

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

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth a summary of the Company's external reinsurance transactions, as well as reinsurance transactions with State Auto Mutual under the Pooling Arrangement, for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
<b>Premiums earned:</b>				
Assumed from external insurers and reinsurers	\$ 1.0	\$ 1.1	\$ 2.1	\$ 2.1
Assumed under Pooling Arrangement	311.5	268.3	626.8	530.8
Ceded to external insurers and reinsurers	(8.5	) (6.0	) (17.4	) (12.0
Ceded under Pooling Arrangement	(208.6	) (216.8	) (418.5	) (432.2
Net assumed premiums earned	\$ 95.4	\$ 46.6	\$ 193.0	\$ 88.7
<b>Losses and loss expenses incurred:</b>				
Assumed from external insurers and reinsurers	\$ 0.6	\$ 0.8	\$ 1.4	\$ 1.5
Assumed under Pooling Arrangement	225.0	191.1	420.3	363.7
Ceded to external insurers and reinsurers	(2.5	) (1.3	) (2.4	) (3.7
Ceded under Pooling Arrangement	(165.6	) (143.5	) (286.8	) (285.7
Net assumed losses and loss expenses incurred	\$ 57.5	\$ 47.1	\$ 132.5	\$ 75.8

Subject to the terms and conditions of the expired Homeowners Quota Share Arrangement ("HO QS Arrangement"), the participating reinsurers' margin was capped at 9.0%, with any excess returned to the State Auto Group in the form of profit commission. For the three and six months ended June 30, 2015, the Company recognized \$1.4 million and \$2.7 million, respectively, of profit commission, which was reflected as a reduction in acquisition and operating expenses on our consolidated statements of income.

**5. Income Taxes**

The following table sets forth the reconciliation between actual federal income tax expense and the amount computed at the indicated statutory rate for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30				Six months ended June 30			
	2015	2014	2015	2014	2015	2014	2015	2014
Amount at statutory rate	\$ 1.2	35 %	\$ 1.1	35 %	\$ 12.8	35 %	\$ 10.8	35 %
Tax-exempt interest and dividends received deduction	(2.3	) (67	) (2.1	) (68	) (4.5	) (12	) (4.2	) (14
Other, net	1.8	52	0.7	24	0.9	2	0.9	3
Valuation allowance	—	—	0.4	12	—	—	(6.8	) (22
Federal income tax expense and effective rate	\$ 0.7	20 %	\$ 0.1	3 %	\$ 9.2	25 %	\$ 0.7	2 %



Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

## 6. Pension and Postretirement Benefit Plans

The following table sets forth the components of net periodic cost for the Company's pension and postretirement benefit plans for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Pension		Postretirement		Pension		Postretirement	
	Three months ended June 30				Six months ended June 30			
	2015	2014	2015	2014	2015	2014	2015	2014
Service cost	\$ 1.9	\$ 1.3	\$—	\$—	\$ 3.9	\$ 2.6	\$—	\$—
Interest cost	2.9	2.8	0.2	0.2	5.7	5.6	0.4	0.5
Expected return on plan assets	(3.5 )	(3.1 )	—	—	(6.9 )	(6.3 )	—	—
Amortization of:								
Negative prior service cost	—	—	(1.4 )	(1.4 )	—	—	(2.8 )	(2.8 )
Net actuarial loss	2.8	2.1	0.1	0.1	5.5	3.5	0.3	0.3
Net periodic cost (benefit)	\$ 4.1	\$ 3.1	\$(1.1 )	\$(1.1 )	\$ 8.2	\$ 5.4	\$(2.1 )	\$(2.0 )

The Company's share of contributions were \$6.5 million for the six months ended June 30, 2015 and expects its remaining share of contributions to be an additional \$6.5 million to the pension plan during 2015.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

## 7. Other Comprehensive Income and Accumulated Other Comprehensive Income

The following table sets forth the changes in the Company's accumulated other comprehensive income component (AOCI), net of tax, for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Total
Beginning balance at April 1, 2015	\$ 118.3	\$(37.3)	) \$81.0
Other comprehensive income before reclassifications	(25.1)	) —	(25.1)
Amounts reclassified from AOCI <sup>(a)</sup>	(3.5)	) 1.0	(2.5)
Net current period other comprehensive (loss) income	(28.6)	) 1.0	(27.6)
Ending balance at June 30, 2015	\$ 89.7	\$(36.3)	) \$53.4
Beginning balance at April 1, 2014	\$ 92.7	\$(3.6)	) \$89.1
Other comprehensive income before reclassifications	31.4	(1.6)	) 29.8
Amounts reclassified from AOCI <sup>(a)</sup>	(5.3)	) 0.8	(4.5)
Net current period other comprehensive income (loss)	26.1	(0.8)	) 25.3
Ending balance at June 30, 2014	\$ 118.8	\$(4.4)	) \$114.4

(a) See separate table below for details about these reclassifications

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Total
Beginning balance at January 1, 2015	\$ 110.0	\$(38.3)	) \$71.7
Other comprehensive income before reclassifications	(14.1)	) —	(14.1)
Amounts reclassified from AOCI <sup>(a)</sup>	(6.2)	) 2.0	(4.2)
Net current period other comprehensive (loss) income	(20.3)	) 2.0	(18.3)
Ending balance at June 30, 2015	\$ 89.7	\$(36.3)	) \$53.4
Beginning balance at January 1, 2014	\$ 84.6	\$(3.8)	) \$80.8
Other comprehensive income before reclassifications	50.2	(1.6)	) 48.6
Amounts reclassified from AOCI <sup>(a)</sup>	(16.0)	) 1.0	(15.0)
Net current period other comprehensive income (loss)	34.2	(0.6)	) 33.6
Ending balance at June 30, 2014	\$ 118.8	\$(4.4)	) \$114.4

(a) See separate table below for details about these reclassifications



Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the reclassifications out of accumulated other comprehensive income, by component, to the Company's condensed consolidated statement of income for the three and six months ended June 30, 2015 and 2014:

(\$ millions)

Details about Accumulated Other Comprehensive Income Components	Three months ended June 30		Affected line item in the Condensed Consolidated Statements of Income
	2015	2014	
Unrealized gains on available for sale securities	\$ 5.4	\$ 5.3	Realized gain on sale of securities
	5.4	5.3	Total before tax
	(1.9	) —	Tax expense
	3.5	5.3	Net of tax
Amortization of benefit plan items			
Negative prior service cost	1.4	1.4	(a)
Net actuarial loss	(2.9	) (2.2	) (a)
	(1.5	) (0.8	) Total before tax
	0.5	—	Tax benefit
	(1.0	) (0.8	) Net of tax
Total reclassifications for the period	\$ 2.5	\$ 4.5	

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see pension and postretirement benefit plans footnote for additional details).

(\$ millions)

Details about Accumulated Other Comprehensive Income Components	Six months ended June 30		Affected line item in the Condensed Consolidated Statements of Income
	2015	2014	
Unrealized gains on available for sale securities	\$ 9.6	\$ 16.0	Realized gain on sale of securities
	9.6	16.0	Total before tax
	(3.4	) —	Tax expense
	6.2	16.0	Net of tax
Amortization of benefit plan items			
Negative prior service cost	2.8	2.8	(a)
Net actuarial loss	(5.8	) (3.8	) (a)
	(3.0	) (1.0	) Total before tax
	1.0	—	Tax benefit
	(2.0	) (1.0	) Net of tax
Total reclassifications for the period	\$ 4.2	\$ 15.0	

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see pension and postretirement benefit plans footnote for additional details).



Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

## 8. Net Earnings per Common Share

The following table sets forth the compilation of basic and diluted earnings per common share for the three and six months ended June 30, 2015 and 2014:

(\$ and shares in millions, except per share amounts)

	Three months ended		Six months ended	
	June 30		June 30	
	2015	2014	2015	2014
Numerator:				
Net income for basic earnings per common share	\$2.7	\$3.0	\$27.4	\$30.1
Denominator:				
Weighted average shares for basic net earnings per common share	41.0	40.8	41.0	40.8
Effect of dilutive share-based awards	0.5	0.4	0.5	0.4
Adjusted weighted average shares for diluted net earnings per common share	41.5	41.2	41.5	41.2
Basic net earnings per common share	\$0.06	\$0.07	\$0.67	\$0.74
Diluted net earnings per common share	\$0.06	\$0.07	\$0.66	\$0.73

The following table sets forth common stock options and restricted share units ("RSU award") provided to each outside director of the Company that were not included in the computation of diluted earnings per common share because the exercise price of the options, or awards, was greater than the average market price or their inclusion would have been antidilutive for the three and six months ended June 30, 2015 and 2014.

(shares in millions)	Three months ended June		Six months ended June 30	
	30		30	
	2015	2014	2015	2014
Total number of antidilutive options and awards	1.8	1.7	1.8	1.7

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

9. Segment Information

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

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

The investment operations segment is evaluated based on investment returns of assets managed by Stateco. Asset information by segment is not reported for the insurance segments because the Company does not produce such information internally.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth financial information regarding the Company's reportable segments for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Revenue from external sources:				
Insurance segments				
Personal insurance	\$ 148.2	\$ 113.7	\$ 298.2	\$ 228.0
Business insurance	96.5	95.9	192.6	189.4
Specialty insurance	66.8	58.7	136.0	113.4
Total insurance segments	311.5	268.3	626.8	530.8
Investment operations segment				
Net investment income	19.8	20.5	35.2	38.1
Net realized capital gains	5.4	5.3	9.6	16.0
Total investment operations segment	25.2	25.8	44.8	54.1
All other	0.7	0.3	0.7	0.8
Total revenue from external sources	337.4	294.4	672.3	585.7
Intersegment revenue	1.4	1.3	2.8	2.6
Total revenue	338.8	295.7	675.1	588.3
Reconciling items:				
Eliminate intersegment revenues	(1.4	) (1.3	) (2.8	) (2.6
Total consolidated revenues	\$ 337.4	\$ 294.4	\$ 672.3	\$ 585.7
Segment income before federal income tax:				
Insurance segments SAP underwriting (loss) income				
Personal insurance	\$(10.2	) \$(10.7	) \$ 7.2	) \$(4.6
Business insurance	(14.8	) (5.9	) (16.2	) (15.3
Specialty insurance	(1.0	) (12.1	) (1.8	) (12.7
Total insurance segments	(26.0	) (28.7	) (10.8	) (32.6
Investment operations segment				
Net investment income	19.8	20.5	35.2	38.1
Net realized capital gains	5.4	5.3	9.6	16.0
Total investment operations segment	25.2	25.8	44.8	54.1
All other	0.1	(0.1	) (0.3	) —
Total segment (loss) income before tax expense	(0.7	) (3.0	) 33.7	) 21.5
Reconciling items:				
GAAP expense adjustments	6.5	8.9	7.7	14.2
Interest expense on corporate debt	(1.4	) (1.3	) (2.7	) (2.6
Corporate expenses	(1.0	) (1.5	) (2.1	) (2.3
Total reconciling items	4.1	6.1	2.9	9.3
Total consolidated income before federal income tax expense	\$ 3.4	\$ 3.1	\$ 36.6	\$ 30.8

For the three and six months ended June 30, 2015, the specialty insurance segment results reflect the impact of a correction of reinsurance amounts related to the Company's reinsurance agreement covering casualty risks within the segment. As a result of the correction, net written and earned premiums were reduced by \$7.6 million and \$5.5 million, respectively, losses were reduced by \$2.1 million and acquisition and operating expenses were reduced by



\$1.6 million.

Investable assets attributable to the Company's investment operations segment totaled \$2,471.7 million and \$2,444.2 million at June 30, 2015 and December 31, 2014, respectively.

23

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

10. Contingencies and Litigation

In accordance with the Contingencies Topic of the Financial Accounting Standards Board's Accounting Standards Codification, the Company accrues for a litigation-related liability when it is probable that such a liability has been incurred and the amount can be reasonably estimated. The Company reviews all litigation on an ongoing basis when making accrual and disclosure decisions. For certain legal proceedings, the Company cannot reasonably estimate losses or a range of loss, if any, particularly for proceedings that are in their early stages of development or where the plaintiffs seek indeterminate damages. Various factors, including, but not limited to, the outcome of potentially lengthy discovery and the resolution of important factual questions, may need to be determined before probability can be established or before a loss or range of loss can be reasonably estimated. If the loss contingency in question is not both probable and reasonably estimable, the Company does not establish an accrual and the matter will continue to be monitored for any developments that would make the loss contingency both probable and reasonably estimable. Based on currently available information known to the Company, it believes that its reserves for litigation-related liabilities are reasonable. However, in the event that a legal proceeding results in a substantial judgment against, or settlement by, the Company, there can be no assurance that any resulting liability or financial commitment would not have a material adverse effect on the financial condition, results of operations or cash flows of the consolidated financial statements of the Company.

The Company is involved in lawsuits in the ordinary course of its business arising out of or otherwise related to its insurance policies. Additionally, from time to time the Company may be involved in lawsuits, including class actions, in the ordinary course of business but not arising out of or otherwise related to its insurance policies. These lawsuits are in various stages of development. The Company generally will contest these matters vigorously but may pursue settlement if appropriate. Based on currently available information, the Company does not believe it is reasonably possible that any such lawsuit or related lawsuits will be material to its results of operations or have a material adverse effect on its consolidated financial position or cash flows.

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

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

The term "State Auto Financial" as used below refers only to State Auto Financial Corporation and the terms "our Company," "we," "us," and "our" as used below refer to State Auto Financial Corporation and its consolidated subsidiaries.

The term "second quarter" as used below refers to the three months ended June 30, for the time period then ended. For a glossary of terms for State Auto Financial Corporation and its subsidiaries and affiliates and a glossary of selected insurance and accounting terms, see the section entitled "Important Defined Terms Used in this Form 10-K" included in our Annual Report on Form 10-K for the year ended December 31, 2014 (the "2014 Form 10-K").

The discussion and analysis presented below relates to the material changes in financial condition and results of operations for our consolidated balance sheets as of June 30, 2015 and December 31, 2014, and for the consolidated statements of income for the three and six month periods ended June 30, 2015 and 2014. This discussion and analysis should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the 2014 Form 10-K, and in particular the discussions in those sections thereof entitled "Overview," "Executive Summary" and "Critical Accounting Policies." Readers are encouraged to review the entire 2014 Form 10-K, as it includes information regarding our Company not discussed in this Form 10-Q. This information will assist in your understanding of the discussion of our current period financial results.

The discussion and analysis presented below includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements generally can be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "estimate," "anticipate," "project," "believe" or "continue" or the negative thereof or variations thereon or similar terminology.

Forward-looking statements speak only as of the date the statements were made available. Although we believe that the expectations reflected in forward-looking statements have a reasonable basis, we can give no assurance that these expectations will prove to be correct. Forward-looking statements are subject to risks and uncertainties that could cause actual events or results to differ materially from those expressed in or implied by the statements. For a discussion of the most significant risks and uncertainties that could cause our actual results to differ materially from those projected, see "Risk Factors" in Item 1A of the 2014 Form 10-K, updated by Part II, Item 1A of this Form 10-Q. Except to the limited extent required by applicable law, we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The Company has four reportable segments: personal insurance, business insurance, specialty insurance and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. The investment operations segment, managed by Stateco, provides investment services. See "Personal and Business Insurance" and "Specialty Insurance" in Item 1 of the 2014 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2015 is set forth in Note 9 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

**POOLING ARRANGEMENT**

The STFC Pooled Companies and the Mutual Pooled Companies participate in a quota share reinsurance pooling arrangement referred to as the "Pooling Arrangement." Under the Pooling Arrangement, State Auto Mutual assumes premiums, losses and expenses from each of the Pooled Companies and in turn cedes to each of the Pooled

Companies a specified portion of premiums, losses and expenses based on each of the Pooled Companies' respective pooling percentages. State Auto Mutual then retains the balance of the pooled business.

25

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

STFC Pooled Companies:

State Auto P&C	51.0	%
Milbank	14.0	
SA Ohio	—	
Total STFC Pooled Companies	65.0	%

State Auto Mutual Pooled Companies:

State Auto Mutual	34.5	%
SA Wisconsin	—	
Meridian Security	—	
Patrons Mutual	0.5	
RIC	—	
Plaza	—	
American Compensation	—	
Bloomington Compensation	—	
Total State Auto Mutual Pooled Companies	35.0	%

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## RESULTS OF OPERATIONS

Our pre-tax income for the three and six months ended June 30, 2015 was \$3.4 million and \$36.6 million, respectively, compared to pre-tax income of \$3.1 million and \$30.8 million, respectively, for the same 2014 periods. Our pre-tax income for the three and six months ended June 30, 2014 was impacted by reserve strengthening of \$11.4 million and \$11.6 million, respectively, for terminated RED programs and severance expenses of \$4.4 million recognized as a result of the reorganization of our information technology department. Excluding the impact of these items and the impact of the expired HO QS Arrangement for the three and six months ended June 30, 2014, our pre-tax income for the three and six months ended June 30, 2015 decreased when compared to the same 2014 periods. The decrease was primarily due to an increase in non-catastrophe losses in both personal and commercial auto and other & product liability lines, declines in net investment income and net realized gains.

The following table sets forth certain key performance indicators we use to monitor our operations for the three and six months ended June 30, 2015 and 2014:

(\$ millions, except per share amounts)	Three months ended June 30		Six months ended June 30		
	2015	2014	2015	2014	
GAAP Basis:					
Total revenues	\$337.4	\$294.4	\$672.3	585.7	
Net income	\$2.7	\$3.0	\$27.4	30.1	
Basic earnings per share	\$0.06	\$0.07	\$0.67	0.74	
Diluted earnings per share	\$0.06	\$0.07	\$0.66	0.73	
Stockholders' equity	\$877.5	\$843.7			
Return on average equity (LTM)	12.2	% 8.4	%		
Book value per share	\$21.35	\$20.65			
Debt to capital ratio	10.3	% 10.7	%		
Cat loss and ALAE ratio	11.4	% 7.9	% 6.4	% 5.2	%
Non-cat loss and LAE ratio	60.7	% 63.1	% 60.5	% 63.0	%
Loss and LAE ratio	72.1	% 71.0	% 66.9	% 68.2	%
Expense ratio	34.0	% 36.3	% 33.4	% 35.0	%
Combined ratio	106.1	% 107.3	% 100.3	% 103.2	%
Premium written growth	15.0	% 3.5	% 15.3	% 2.1	%
Investment yield	3.5	% 3.8	% 3.1	% 3.6	%
SAP Basis:					
Cat loss and ALAE ratio	11.4	% 7.9	% 6.4	% 5.2	%
Non-cat loss and ALAE ratio	54.2	% 56.9	% 54.2	% 57.0	%
ULAE ratio	6.6	% 6.5	% 6.5	% 6.3	%
Loss and LAE ratio	72.2	% 71.3	% 67.1	% 68.5	%
Expense ratio	33.2	% 35.8	% 33.6	% 35.6	%
Combined ratio	105.4	% 107.1	% 100.7	% 104.1	%
(\$ millions)	Twelve months ended June 30				
	2015	2014			
Net premiums written to surplus	1.6	1.4			

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Homeowners Quota Share Arrangement

To reduce risk and volatility in our homeowners line of business, while at the same time providing additional catastrophe reinsurance protection, the State Auto Group entered into a quota share reinsurance agreement on December 31, 2011 with a syndicate of unaffiliated reinsurers covering its homeowners line of business (the “HO QS Arrangement”). Under the HO QS Arrangement, the State Auto Group ceded to the reinsurers 75% of its homeowners business under policies in force at December 31, 2011 and new and renewal policies thereafter issued during the term of the agreement. The HO QS Arrangement expired on December 31, 2014. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources – Reinsurance Arrangements” in Item 7 of the 2014 Form 10-K for a discussion of the expired HO QS Arrangement.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following tables set forth, on an as reported and pro forma GAAP basis, certain of our key performance indicators before and after the impact of our HO QS Arrangement cession for the three and six months ended June 30, 2014:

## Reconciliation Tables 1 - 2

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession	Cession	
Three months ended June 30, 2014				
Net written premiums	\$ 295.1	\$ 48.6	\$ 343.7	
Earned premiums	268.3	44.1	312.4	
Losses and LAE incurred:				
Cat loss and ALAE	21.2	15.6	36.8	
Non-cat loss and LAE	169.2	18.3	187.5	
Total Loss and LAE incurred	190.4	33.9	224.3	
Acquisition and operating expenses	97.3	12.8	110.1	
Net underwriting loss	\$ (19.4 )	\$ (2.6 )	\$ (22.0 )	
Cat loss and ALAE ratio	7.9	% 35.3	% 11.8	%
Non-cat loss and LAE ratio	63.1	% 41.7	% 60.0	%
Total Loss and LAE ratio	71.0	% 77.0	% 71.8	%
Expense ratio	36.3	% 29.0	% 35.2	%
Combined ratio	107.3	% 106.0	% 107.0	%

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession	Cession	
Six months ended June 30, 2014				
Net written premiums	\$ 560.5	\$ 86.5	\$ 647.0	
Earned premiums	530.8	88.3	619.1	
Losses and LAE incurred:				
Cat loss and ALAE	27.5	18.0	45.5	
Non-cat loss and LAE	334.7	38.8	373.5	
Total Loss and LAE incurred	362.2	56.8	419.0	
Acquisition and operating expenses	185.8	25.6	211.4	
Net underwriting (loss) gain	\$ (17.2 )	\$ 5.9	\$ (11.3 )	
Cat loss and ALAE ratio	5.2	% 20.4	% 7.3	%
Non-cat loss and LAE ratio	63.0	% 43.9	% 60.4	%
Total Loss and LAE ratio	68.2	% 64.3	% 67.7	%
Expense ratio	35.0	% 29.0	% 34.1	%
Combined ratio	103.2	% 93.3	% 101.8	%





Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following tables set forth, on an as reported and pro forma SAP basis, certain of our key performance indicators before and after the impact of the HO QS Arrangement cession for the three and six months ended June 30, 2014:

## Reconciliation Tables 3 - 4

(\$ millions)	SAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession		
Three months ended June 30, 2014				
Net written premiums	\$ 295.1	\$ 48.6		\$ 343.7
Earned premiums	268.3	44.1		312.4
Losses and LAE incurred:				
Cat loss and ALAE	21.2	15.6		36.8
Non-cat loss and ALAE	152.5	18.3		170.8
Total Loss and ALAE	173.7	33.9		207.6
ULAE	17.5	—		17.5
Total Loss and ALAE incurred	191.2	33.9		225.1
Underwriting expenses	105.8	14.1		119.9
Net underwriting loss	\$(28.7)	\$(3.9)		\$(32.6)
Cat loss and ALAE ratio	7.9	% 35.3		% 11.8
Non-cat loss and ALAE ratio	56.9	% 41.7		% 54.7
Total loss and ALAE ratio	64.8	% 77.0		% 66.5
ULAE ratio	6.5	% —		5.6
Total loss and LAE ratio	71.3	% 77.0		% 72.1
Expense ratio	35.8	% 29.0		% 34.9
Combined ratio	107.1	% 106.0		% 107.0

(\$ millions)	SAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession		
Six months ended June 30, 2014				
Net written premiums	\$ 560.5	\$ 86.5		\$ 647.0
Earned premiums	530.8	88.3		619.1
Losses and LAE incurred:				
Cat loss and ALAE	27.5	18.0		45.5
Non-cat loss and ALAE	302.9	38.8		341.7
Total Loss and ALAE	330.4	56.8		387.2
ULAE	33.4	—		33.4
Total Loss and ALAE incurred	363.8	56.8		420.6
Underwriting expenses	199.6	25.1		224.7
Net underwriting (loss) gain	\$(32.6)	\$ 6.4		\$(26.2)
Cat loss and ALAE ratio	5.2	% 20.4		% 7.3

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

Non-cat loss and ALAE ratio	57.0	% 43.9	% 55.2	%
Total loss and ALAE ratio	62.2	% 64.3	% 62.5	%
ULAE ratio	6.3	% —	5.4	%
Total loss and LAE ratio	68.5	% 64.3	% 67.9	%
Expense ratio	35.6	% 29.0	% 34.7	%
Combined ratio	104.1	% 93.3	% 102.6	%

30

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

See additional pro forma reconciliation tables for the impact of the HO QS Arrangement cession on our homeowners line of business at Reconciliation Tables 5 and 6 and our personal insurance segment at Reconciliation Tables 7 and 8.

Use of Non-GAAP Financial Measures

In discussing the results of our insurance segments, we sometimes refer to GAAP financial measures in the context of “as reported” and to non-GAAP financial measures in the context of “pro forma.” In the personal insurance segment, these pro forma amounts or percentages exclude the impact of the expired HO QS Arrangement cession for the three and six months ended June 30, 2014. In the specialty insurance segment, these pro forma amounts or percentages exclude the impact of a correction of reinsurance amounts for the three and six months ended June 30, 2015 relating to a casualty reinsurance agreement covering casualty risks within this segment. We believe the use of these non-GAAP financial measures will enable investors to (a) better understand the impact of the reinsurance arrangement cession and the reinsurance correction on our reported results for the three and six months ended June 30, 2015 and 2014, and (b) perform a meaningful comparison of our results of operations for the three and six months ended June 30, 2015 and 2014. We have also included Reconciliation Tables 1 - 8, Tables 1 - 9, and tables in footnotes on pages 35 and 41 for readers to better understand the use and calculation of these non-GAAP financial measures.

Insurance Segments

The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners coverages to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages requiring 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.

We measure our top-line growth for our insurance segments based on net written premiums, which provide us with an indication of how well we are doing in terms of revenue growth before it is actually earned. Our policies provide a fixed amount of coverage for a stated period of time, often referred to as the “policy term.” As such, our written premiums are recognized as earned ratably over the policy term. The unearned portion of written premiums, called unearned premiums, is reflected on our balance sheet as a liability and represents our obligation to provide coverage for the unexpired term of the policies.

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

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred acquisition costs, see “Critical Accounting Policies – Deferred Acquisition Costs” section included in Item 7 of our 2014 Form 10-K.

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

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following tables sets forth our insurance segments' SAP underwriting (loss) gain and SAP combined ratios for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30, 2015							
	Personal	% Ratio	Business	% Ratio	Specialty	% Ratio	Total	% Ratio
Net written premiums	\$ 155.9		\$ 107.8		\$ 75.6		\$ 339.3	
Earned premiums	148.2		96.5		66.8		311.5	
Cat loss and ALAE	24.4	16.5	10.9	11.3	0.2	0.2	35.5	11.4
Non-cat loss and ALAE	77.7	52.3	54.1	56.1	37.2	55.9	169.0	54.2
ULAE	11.3	7.7	5.7	5.8	3.5	5.2	20.5	6.6
Underwriting expenses	45.0	29.0	40.6	37.6	26.9	35.5	112.5	33.2
SAP underwriting loss and SAP combined ratio	\$(10.2 )	105.5	\$(14.8 )	110.8	\$(1.0 )	96.8	\$(26.0 )	105.4

(\$ millions)	Three months ended June 30, 2014							
	Personal	% Ratio	Business	% Ratio	Specialty	% Ratio	Total	% Ratio
Net written premiums	\$ 116.3		\$ 107.0		\$ 71.8		\$ 295.1	
Earned premiums	113.7		95.9		58.7		268.3	
Cat loss and ALAE	12.0	10.5	8.2	8.6	1.0	1.8	21.2	7.9
Non-cat loss and ALAE	64.6	56.8	46.9	48.9	41.0	69.8	152.5	56.9
ULAE	11.2	9.8	4.8	4.9	1.5	2.7	17.5	6.5
Underwriting expenses	36.6	31.5	41.9	39.1	27.3	38.0	105.8	35.8
SAP underwriting loss and SAP combined ratio	\$(10.7 )	108.6	\$(5.9 )	101.5	\$(12.1 )	112.3	\$(28.7 )	107.1

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

(\$ millions)	Six months ended June 30, 2015							
	Personal	% Ratio	Business	% Ratio	Specialty	% Ratio	Total	% Ratio
Net written premiums	\$ 293.0		\$ 200.4		\$ 152.9		\$ 646.3	
Earned premiums	298.2		192.6		136.0		626.8	
Cat loss and ALAE	27.5	9.2	12.3	6.4	0.2	0.1	40.0	6.4
Non-cat loss and ALAE	155.1	52.0	107.6	55.9	77.2	56.8	339.9	54.2
ULAE	24.0	8.1	10.6	5.5	5.8	4.3	40.4	6.5
Underwriting expenses	84.4	28.8	78.3	39.1	54.6	35.7	217.3	33.6
SAP underwriting gain (loss) and SAP combined ratio	\$ 7.2	98.1	\$(16.2)	106.9	\$(1.8)	96.9	\$(10.8)	100.7

(\$ millions)	Six months ended June 30, 2014							
	Personal	% Ratio	Business	% Ratio	Specialty	% Ratio	Total	% Ratio
Net written premiums	\$ 225.9		\$ 201.6		\$ 133.0		\$ 560.5	
Earned premiums	228.0		189.4		113.4		530.8	
Cat loss and ALAE	12.4	5.4	13.4	7.1	1.7	1.5	27.5	5.2
Non-cat loss and ALAE	129.7	56.9	102.9	54.3	70.3	62.0	302.9	57.0
ULAE	21.3	9.4	8.6	4.5	3.5	3.1	33.4	6.3
Underwriting expenses	69.2	30.6	79.8	39.6	50.6	38.0	199.6	35.6
SAP underwriting loss and SAP combined ratio	\$(4.6)	102.3	\$(15.3)	105.5	\$(12.7)	104.6	\$(32.6)	104.1

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Personal Insurance Segment

The following table sets forth the net written premiums by major product line of business for our personal insurance segment for the three and six months ended June 30, 2015 and 2014:

Table 1

(\$ millions)	Net Written Premiums					
	Three months ended June 30			Six months ended June 30		
	2015	2014	% Change	2015	2014	% Change
Personal insurance segment:						
Personal auto	\$ 86.3	\$ 92.0	(6.2)	\$ 168.7	\$ 181.5	(7.1)
Homeowners	60.8	16.3	273.0	107.3	28.8	272.6
Other personal	8.8	8.0	10.0	17.0	15.6	9.0
Total personal	\$ 155.9	\$ 116.3	34.0	\$ 293.0	\$ 225.9	29.7

The following tables set forth the SAP loss and ALAE ratios by major product line of business for our personal insurance segment with the catastrophe and non-catastrophe impact shown separately for the three and six months ended June 30, 2015 and 2014:

Table 2

Three months ended June 30	Statutory Loss and LAE Ratios (\$ millions)				%		Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	
2015							
Personal insurance segment:							
Personal auto	\$ 84.9	\$ 3.7	\$ 56.4	\$ 60.1	4.4	66.3	70.7
Homeowners	55.2	19.4	19.2	38.6	35.1	34.7	69.8
Other personal	8.1	1.3	2.1	3.4	16.1	26.5	42.6
Total personal	148.2	24.4	77.7	102.1	16.5	52.3	68.8
ULAE	—	—	—	11.3	—	—	7.7
Total Loss and LAE	\$ 148.2	\$ 24.4	\$ 77.7	\$ 113.4	16.5	52.3	76.5
2014							
Personal insurance segment:							
Personal auto	\$ 91.4	\$ 5.3	\$ 56.4	\$ 61.7	5.9	61.5	67.4
Homeowners	14.8	4.8	4.2	9.0	31.8	28.8	60.6
Other personal	7.5	1.9	4.0	5.9	25.5	53.9	79.4
Total personal	113.7	12.0	64.6	76.6	10.5	56.8	67.3
ULAE	—	—	—	11.2	—	—	9.8
Total Loss and LAE	\$ 113.7	\$ 12.0	\$ 64.6	\$ 87.8	10.5	56.8	77.1

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Table 3

Statutory Loss and LAE Ratios (\$ millions)

Six months ended June 30				%			Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	
2015							
Personal insurance segment:							
Personal auto	\$ 171.0	\$ 3.7	\$ 111.5	\$ 115.2	2.2	65.1	67.3
Homeowners	111.1	22.4	40.1	62.5	20.1	36.1	56.2
Other personal	16.1	1.4	3.5	4.9	9.0	21.6	30.6
Total personal	298.2	27.5	155.1	182.6	9.2	52.0	61.2
ULAE	—	—	—	24.0	—	—	8.1
Total Loss and LAE	\$ 298.2	\$ 27.5	\$ 155.1	\$ 206.6	9.2	52.0	69.3
2014							
Personal insurance segment:							
Personal auto	\$ 183.8	\$ 5.2	\$ 112.1	\$ 117.3	2.9	60.9	63.8
Homeowners	29.4	5.4	11.4	16.8	18.2	39.0	57.2
Other personal	14.8	1.8	6.2	8.0	12.2	41.9	54.1
Total personal	228.0	12.4	129.7	142.1	5.4	56.9	62.3
ULAE	—	—	—	21.3	—	—	9.4
Total Loss and LAE	\$ 228.0	\$ 12.4	\$ 129.7	\$ 163.4	5.4	56.9	71.7

The personal insurance segment's net written premiums for the three and six months ended June 30, 2015 increased 34.0% and 29.7%, respectively, compared to the same 2014 periods (Table 1). Net written premiums for the three and six months ended June 30, 2014 included the cession of premiums under the expired HO QS Arrangement. Excluding the impact of the expired HO QS Arrangement, net written premiums decreased 5.5%<sup>(1)</sup> and 6.2%<sup>(1)</sup> for the three and six months ended June 30, 2015, respectively, compared to the same 2014 periods, primarily due to continued declines in new business within personal auto and homeowners. We have undertaken steps to improve new business writings, including the introduction of the "Start-up Discount" in 2014 which is now in 24 states.

<sup>(1)</sup> For the three and six months ended June 30, 2015 and 2014, respectively, the following table sets forth the reconciliation of as reported net written premiums to 2014 pro forma net written premiums after excluding the impact of the net written premium cession under the expired HO QS Arrangement:

(\$ millions)	Three months ended June 30			Six months ended June 30		
	2015	2014	% Change	2015	2014	% Change
Net written premiums:						
Personal insurance segment	\$ 155.9	\$ 116.3	34.0	\$ 293.0	\$ 225.9	29.7
HO QS cession	—	48.6	(100.0 )	—	86.5	(100.0 )
Pro forma net written premiums	\$ 155.9	\$ 164.9	(5.5 )	\$ 293.0	\$ 312.4	(6.2 )

The personal insurance segment's as reported SAP catastrophe loss ratios for the three and six months ended June 30, 2015 were comparable to the pro forma SAP catastrophe loss ratios for the same 2014 periods (Tables 2 - 3 and Reconciliation Tables 7 - 8).



The personal segment's as reported SAP non-catastrophe loss and ALAE ratios for the three and six months ended June 30, 2015 were 52.3% and 52.0% (Tables 2 - 3) compared to pro forma SAP non-catastrophe loss and ALAE ratios of 52.5% and 53.3% for the same 2014 periods (Reconciliation Tables 7 - 8). The three and six month June 30, 2015 improvements, when compared to the same 2014 periods, were primarily due to homeowners SAP non-catastrophe loss and ALAE ratio improvements of 3.8 points and 6.7 points, respectively (Tables 2 - 3 and Reconciliation Tables 5 - 6), primarily driven by a decrease in the frequency and severity of large losses during the first half of 2015 when compared to the same 2014 period. The improvements were partially offset by an increase in the personal auto SAP non-catastrophe loss and ALAE ratios of 4.8 points and 4.2 points, respectively,

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

when compared to the same 2014 periods (Tables 2 - 3), primarily driven by bodily injury losses as a result of greater severity and more reported claims than expected for the 2013 and 2014 accident years.

The following tables set forth, on an as reported and pro forma SAP basis, certain of our key performance indicators for the homeowners' line of business and the personal insurance segment before and after the impact of the HO QS Arrangement cession for the three and six months ended June 30, 2014:

Reconciliation Tables 5 - 6

(\$ millions)	SAP HO QS Arrangement Cession - Homeowners			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession		
Three months ended June 30, 2014				
Net written premiums	\$ 16.3	\$ 48.6		\$ 64.9
Earned premiums	14.8	44.1		58.9
Losses and ALAE incurred:				
Cat loss and ALAE	4.8	15.6		20.4
Non-cat loss and ALAE	4.2	18.3		22.5
Total Loss and ALAE incurred	\$ 9.0	\$ 33.9		\$ 42.9
Cat loss and ALAE ratio	31.8	% 35.3	% 34.4	%
Non-cat loss and ALAE ratio	28.8	% 41.7	% 38.5	%
Total Loss and ALAE ratio	60.6	% 77.0	% 72.9	%

(\$ millions)	SAP HO QS Arrangement Cession - Homeowners			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession		
Six months ended June 30, 2014				
Net written premiums	\$ 28.8	\$ 86.5		\$ 115.3
Earned premiums	29.4	88.3		117.7
Losses and ALAE incurred:				
Cat loss and ALAE	5.4	18.0		23.4
Non-cat loss and ALAE	11.4	38.8		50.2
Total Loss and ALAE incurred	\$ 16.8	\$ 56.8		\$ 73.6
Cat loss and ALAE ratio	18.2	% 20.4	% 19.8	%
Non-cat loss and ALAE ratio	39.0	% 43.9	% 42.8	%
Total Loss and ALAE ratio	57.2	% 64.3	% 62.6	%

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Reconciliation Tables 7 - 8

(\$ millions)	SAP HO QS Arrangement Cession - Personal Insurance Segment			
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession	
Three months ended June 30, 2014				
Net written premiums	\$ 116.3	\$ 48.6	\$ 164.9	
Earned premiums	113.7	44.1	157.8	
Losses and ALAE incurred:				
Cat loss and ALAE	12.0	15.6	27.6	
Non-cat loss and ALAE	64.6	18.3	82.9	
Total Loss and ALAE incurred	\$ 76.6	\$ 33.9	\$ 110.5	
Cat loss and ALAE ratio	10.5	% 35.3	% 17.5	%
Non-cat loss and ALAE ratio	56.8	% 41.7	% 52.5	%
Total Loss and ALAE ratio	67.3	% 77.0	% 70.0	%

(\$ millions)	SAP HO QS Arrangement Cession - Personal Insurance Segment			
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession	
Six months ended June 30, 2014				
Net written premiums	\$ 225.9	\$ 86.5	\$ 312.4	
Earned premiums	228.0	88.3	316.3	
Losses and ALAE incurred:				
Cat loss and ALAE	12.4	18.0	30.4	
Non-cat loss and ALAE	129.7	38.8	168.5	
Total Loss and ALAE incurred	\$ 142.1	\$ 56.8	\$ 198.9	
Cat loss and ALAE ratio	5.4	% 20.4	% 9.6	%
Non-cat loss and ALAE ratio	56.9	% 43.9	% 53.3	%
Total Loss and ALAE ratio	62.3	% 64.3	% 62.9	%

## Business Insurance Segment

The following table sets forth the net written premiums by major product line of business for our business insurance segment for the three and six months ended June 30, 2015 and 2014:

Table 4

(\$ millions)	Net Written Premiums					
	Three months ended June 30			Six months ended June 30		
Business insurance segment:	2015	2014	% Change	2015	2014	% Change
Commercial auto	\$ 29.6	\$ 28.7	3.1	\$ 53.0	\$ 53.1	(0.2 )

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

Commercial multi-peril	31.0	31.5	(1.6 )	61.0	61.7	(1.1 )
Fire & allied lines	19.7	20.2	(2.5 )	37.1	38.6	(3.9 )
Other & product liability	22.7	21.6	5.1	40.5	38.8	4.4
Other commercial	4.8	5.0	(4.0 )	8.8	9.4	(6.4 )
Total business	\$ 107.8	\$ 107.0	0.7	\$ 200.4	\$ 201.6	(0.6 )

37

---

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following table sets forth the SAP loss and ALAE ratios by major product line of business for our business insurance segment with the catastrophe and non-catastrophe impact shown separately for the three and six months ended June 30, 2015 and 2014:

Table 5

Statutory Loss and LAE Ratios (\$ millions)

Three months ended June 30	(\$ millions)				%		
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	Total Loss and LAE Ratio
2015							
Business insurance segment:							
Commercial auto	\$25.2	\$0.3	\$17.9	\$18.2	1.4	70.8	72.2
Commercial multi-peril	30.0	4.5	16.7	21.2	14.8	55.9	70.7
Fire & allied lines	18.7	6.1	7.6	13.7	32.5	40.7	73.2
Other & product liability	18.3	—	10.6	10.6	0.1	57.5	57.6
Other commercial	4.3	—	1.3	1.3	0.7	30.8	31.5
Total business	96.5	10.9	54.1	65.0	11.3	56.1	67.4
ULAE	—	—	—	5.7	—	—	5.8
Total Loss and LAE	\$96.5	\$10.9	\$54.1	\$70.7	11.3	56.1	73.2
2014							
Business insurance segment:							
Commercial auto	\$24.5	\$0.4	\$12.7	\$13.1	1.9	51.7	53.6
Commercial multi-peril	29.4	3.4	15.6	19.0	11.3	53.4	64.7
Fire & allied lines	19.5	4.5	11.2	15.7	23.1	57.1	80.2
Other & product liability	18.1	—	6.2	6.2	—	34.2	34.2
Other commercial	4.4	(0.1)	1.2	1.1	(1.3)	26.9	25.6
Total business	95.9	8.2	46.9	55.1	8.6	48.9	57.5
ULAE	—	—	—	4.8	—	—	4.9
Total Loss and LAE	\$95.9	\$8.2	\$46.9	\$59.9	8.6	48.9	62.4

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Table 6

Six months ended June 30	(\$ millions)			%			
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	Total Loss and LAE Ratio
2015							
Business insurance segment:							
Commercial auto	\$ 50.5	\$ 0.3	\$ 34.5	\$ 34.8	0.7	68.2	68.9
Commercial multi-peril	59.9	5.2	32.4	37.6	8.7	54.0	62.7
Fire & allied lines	37.5	6.8	18.0	24.8	18.0	48.1	66.1
Other & product liability	36.1	—	20.3	20.3	—	56.2	56.2
Other commercial	8.6	—	2.4	2.4	0.3	28.6	28.9
Total business	192.6	12.3	107.6	119.9	6.4	55.9	62.3
ULAE	—	—	—	10.6	—	—	5.5
Total Loss and LAE	\$ 192.6	\$ 12.3	\$ 107.6	\$ 130.5	6.4	55.9	67.8
2014							
Business insurance segment:							
Commercial auto	\$ 48.5	\$ 0.5	\$ 25.8	\$ 26.3	1.1	53.1	54.2
Commercial multi-peril	58.1	5.4	35.0	40.4	9.2	60.4	69.6
Fire & allied lines	38.9	7.6	23.1	30.7	19.5	59.3	78.8
Other & product liability	35.1	—	16.2	16.2	—	46.1	46.1
Other commercial	8.8	(0.1)	2.8	2.7	(1.1)	31.6	30.5
Total business	189.4	13.4	102.9	116.3	7.1	54.3	61.4
ULAE	—	—	—	8.6	—	—	4.5
Total Loss and LAE	\$ 189.4	\$ 13.4	\$ 102.9	\$ 124.9	7.1	54.3	65.9

Net written premiums for the business insurance segment for the three and six months ended June 30, 2015 were flat when compared to the same 2014 periods (Table 4).

The business insurance segment's SAP catastrophe loss ratio for the three months ended June 30, 2015 was 11.3% compared to 8.6% for the same 2014 period (Table 5). The increase from 2014 was primarily driven by a large loss in the fire & allied lines that occurred during the second quarter 2015. The business insurance segment's SAP catastrophe loss ratio for the six months ended June 30, 2015 improved 0.7 points when compared to the same 2014 period (Table 6), primarily due to less severe weather events during the first half of 2015 when compared to the same 2014 period. The business insurance segment's SAP non-catastrophe loss and ALAE ratios for the three and six months ended June 30, 2015 increased 7.2 points and 1.6 points, respectively, when compared to the same 2014 periods (Tables 5 - 6), primarily driven by commercial auto and other & product liability lines. For the three and six months ended June 30, 2015, the commercial auto SAP non-catastrophe loss and ALAE ratios increased 19.1 points and 15.1 points, respectively, primarily due to higher severity trends for both commercial auto liability and physical damage coverages (Tables 5 - 6). The elevated severity trends were the primary contributors to adverse development of prior accident year losses during the three and six months ended June 30, 2015 compared to favorable development for the three and six months ended June 30, 2014. The three month increase in other & product liability was primarily due to an increase in the severity of losses during the second quarter 2015 when compared to the same 2014 period. Also contributing to the increase for the six months ended June 30, 2015 was less favorable development of prior accident year losses. The commercial auto and other & product liability increases were offset by improvements in the

commercial multi-peril and fire & allied lines SAP non-catastrophe loss and ALAE ratios. The first half of 2014 was impacted by large fire losses as well as the extreme cold weather during the first quarter of 2014.

39

---

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Specialty Insurance Segment

The following table sets forth the net written premiums by unit for our specialty insurance segment for the three and six months ended June 30, 2015 and 2014.

Table 7

(\$ millions)

	Net Written Premiums					
	Three months ended June 30			Six months ended June 30		
Specialty insurance segment:	2015	2014	% Change	2015	2014	% Change
E&S property	\$ 13.4	\$ 18.2	(26.4 )	\$ 21.7	\$ 25.8	(15.9 )
E&S casualty Programs	10.6	14.1	(24.8 )	28.0	26.0	7.7
Workers' compensation	28.5	19.2	48.4	57.2	39.7	44.1
Total specialty	23.1	20.3	13.8	46.0	41.5	10.8
	\$ 75.6	\$ 71.8	5.3	\$ 152.9	\$ 133.0	15.0

The following table sets forth SAP loss and ALAE ratios for our specialty insurance segment with the catastrophe and non-catastrophe impact shown separately for the three and six months ended June 30, 2015 and 2014:

Table 8

Statutory Loss and LAE Ratios (\$ millions)

Three months ended June 30	(\$ millions)			%			Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	
2015							
Specialty insurance segment:							
E&S property	\$ 9.4	\$ 0.1	\$ 0.8	\$ 0.9	0.6	9.8	10.4
E&S casualty	10.4	—	7.1	7.1	—	68.1	68.1
Programs	24.7	0.1	16.6	16.7	0.3	67.4	67.7
Workers' compensation	22.3	—	12.7	12.7	—	56.8	56.8
Total specialty	66.8	0.2	37.2	37.4	0.2	55.9	56.1
ULAE	—	—	—	3.5	—	—	5.2
Total Loss and LAE	\$ 66.8	\$ 0.2	\$ 37.2	\$ 40.9	0.2	55.9	61.3
2014							
Specialty insurance segment:							
E&S property	\$ 10.6	\$ 1.0	\$ 1.3	\$ 2.3	9.6	12.0	21.6
E&S casualty	11.1	—	5.2	5.2	—	46.5	46.5
Programs	18.3	—	23.5	23.5	0.2	128.7	128.9
Workers' compensation	18.7	—	11.0	11.0	—	59.1	59.1
Total specialty	58.7	1.0	41.0	42.0	1.8	69.8	71.6
ULAE	—	—	—	1.5	—	—	2.7
Total Loss and LAE	\$ 58.7	\$ 1.0	\$ 41.0	\$ 43.5	1.8	69.8	74.3





Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Table 9

Statutory Loss and LAE Ratios	(\$ millions)			%			
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	Total Loss and LAE Ratio
Six months ended June 30							
2015							
Specialty insurance segment:							
E&S property	\$ 19.6	\$ 0.1	\$ 2.5	\$ 2.6	0.3	13.1	13.4
E&S casualty	26.0	—	16.1	16.1	—	61.9	61.9
Programs	46.9	0.1	32.5	32.6	0.1	69.5	69.6
Workers' compensation	43.5	—	26.1	26.1	—	60.0	60.0
Total specialty	136.0	0.2	77.2	77.4	0.1	56.8	56.9
ULAE	—	—	—	5.8	—	—	4.3
Total Loss and LAE	\$ 136.0	\$ 0.2	\$ 77.2	\$ 83.2	0.1	56.8	61.2
2014							
Specialty insurance segment:							
E&S property	\$ 18.7	\$ 1.7	\$ 1.7	\$ 3.4	9.2	8.9	18.1
E&S casualty	21.6	—	10.2	10.2	—	47.2	47.2
Programs	36.2	—	35.5	35.5	0.1	98.0	98.1
Workers' compensation	36.9	—	22.9	22.9	—	62.1	62.1
Total specialty	113.4	1.7	70.3	72.0	1.5	62.0	63.5
ULAE	—	—	—	3.5	—	—	3.1
Total Loss and LAE	\$ 113.4	\$ 1.7	\$ 70.3	\$ 75.5	1.5	62.0	66.6

Net written premiums for the specialty insurance segment for the three and six months ended June 30, 2015 increased 5.3% and 15.0%, respectively, compared to the same 2014 periods (Table 7). For the three and six months ended June 30, 2015, the specialty insurance segment was impacted by a correction of reinsurance amounts relating to our reinsurance agreement covering casualty risks within this segment. As a result of this correction, net written and earned premiums were reduced by \$7.6 million and \$5.5 million, respectively, and losses were reduced by \$2.1 million.

Excluding the impact of the reinsurance correction, net written premiums for the three and six months ended June 30, 2015 increased 15.9%<sup>(2)</sup> and 20.7%<sup>(2)</sup>, respectively, when compared to the same 2014 periods. The increase was driven by (i) the Partners General Agency acquisition in the second quarter of 2014, (ii) growth in mono-line workers' compensation business, and (iii) new programs added during the second half of 2014. Partially offsetting this growth was continued intense competition within the catastrophe-exposed property marketplace, which has contributed to less favorable pricing opportunities in the E&S property unit.

<sup>(2)</sup> For the three and six months ended June 30, 2015 and 2014, respectively, the following table sets forth the reconciliation of as reported net written premiums to 2015 pro forma net written premiums after excluding the impact of the reinsurance correction.

(\$ millions)	Three months ended June 30			Six months ended June 30		
	2015	2014	% Change	2015	2014	% Change
Net written premiums:						
Specialty insurance segment	\$ 75.6	\$ 71.8	5.3	\$ 152.9	\$ 133.0	15.0

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

Reinsurance correction	7.6	—	100.0	7.6	—	100.0
Pro forma net written premiums	\$83.2	\$71.8	15.9	\$160.5	\$133.0	20.7

The specialty insurance segment's SAP non-catastrophe loss and ALAE ratios for the three and six months ended June 30, 2015 improved 13.9 points and 5.2 points, respectively, when compared to the same 2014 periods (Tables 8 - 9). The SAP non-catastrophe loss and ALAE ratios for the three and six months ended June 30, 2015 were impacted by the reinsurance correction (discussed above), which added 1.5 points and 0.8 points, respectively. The SAP non-catastrophe loss and ALAE ratios for the three and six months ended June 30, 2014 reflect RED reserve strengthening, which added 19.3 points and 10.2 points, respectively. Absent the reinsurance correction in the second quarter of 2015 and RED reserve strengthening in the second quarter of 2014, the

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

increase in the SAP non-catastrophe loss and ALAE ratios for the three and six months ended June 30, 2015, when compared to the same 2014 periods, was primarily due to (i) a shift in the business mix in the E&S casualty unit attributable to the Partners General Agency acquisition in the second quarter of 2014 and (ii) adverse development of prior accident year losses within the Programs unit.

Losses and loss expenses payable

The following table sets forth losses and loss expenses payable by major line of business at June 30, 2015 and December 31, 2014:

(\$ millions)	June 30, 2015	December 31, 2014	\$ Change
Personal insurance segment:			
Personal auto	\$ 173.1	\$ 176.0	\$(2.9 )
Homeowners	43.2	18.2	25.0
Other personal	8.2	7.7	0.5
Total personal	224.5	201.9	22.6
Business insurance segment:			
Commercial auto	84.3	79.0	5.3
Commercial multi-peril	100.3	94.2	6.1
Fire & allied lines	26.9	19.9	7.0
Other & product liability	155.4	154.2	1.2
Other business	2.5	2.5	—
Total business	369.4	349.8	19.6
Specialty insurance segment:			
E&S property	10.0	8.3	1.7
E&S casualty	79.4	69.9	9.5
Programs	171.5	190.1	(18.6 )
Workers' compensation	159.2	153.6	5.6
Total specialty	420.1	421.9	(1.8 )
Total losses and loss expenses payable, net of reinsurance recoverable on losses and loss expenses payable	\$ 1,014.0	\$ 973.6	\$ 40.4

Losses and loss expenses payable increased \$40.4 million since December 31, 2014. The increase in the homeowners losses and loss expenses payable balance was attributable to fewer ceded losses and loss expenses due to the absence of the HO QS Arrangement in 2015 compared to December 31, 2014. The change in the Programs losses and loss expenses payable balance was primarily due to payments on outstanding RED claims during the first half of 2015. We conduct quarterly reviews of loss development reports and make judgments in determining the reserves for ultimate losses and loss expenses payable. Several factors are considered by us when estimating ultimate liabilities including consistency in relative case reserve adequacy, consistency in claims settlement practices, recent legal developments, historical data, actuarial projections, accounting projections, exposure changes, anticipated inflation, current business conditions, catastrophe developments, late reported claims, and other reasonableness tests. The risks and uncertainties inherent in our estimates include, but are not limited to, actual settlement experience different from historical data, trends, changes in business and economic conditions, court decisions creating unanticipated liabilities, ongoing interpretation of policy provisions by the courts, inconsistent decisions in lawsuits regarding coverage and additional information discovered before settlement of claims. Our results of operations and financial condition could be impacted, perhaps significantly, in the future if the ultimate payments required for claims settlement vary from the liability currently recorded. For a discussion of our reserving methodologies as well as a

measure of sensitivity discussion see “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies – Losses and Loss Expenses Payable” in Item 7 of the 2014 Form 10-K.

42

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Acquisition and Operating Expenses

Our GAAP acquisition and operating expense ratios were 34.0% and 33.4%, respectively, for the three and six months ended June 30, 2015 compared to 36.3% and 35.0%, respectively, for the same 2014 periods.

Excluding the impact of the HO QS Arrangement, acquisition and operating expenses for the three and six months ended June 30, 2015 decreased \$4.2 million and \$2.1 million, respectively, when compared to the same 2014 periods (Reconciliation Tables 1 - 2). Partially offsetting acquisition and operating expenses for the three and six months ended June 30, 2015 was (i) the recognition of \$1.4 million and \$2.7 million, respectively, of profit commission in accordance with the terms of the expired HO QS Arrangement and (ii) the recognition of \$1.6 million of additional ceding commission as a result of the casualty reinsurance correction within the specialty insurance segment. The acquisition and operating expenses for the three and six months ended June 30, 2014 included \$4.4 million of severance expenses recognized as a result of the reorganization of our information technology department.

Investment Operations Segment

Our investments in fixed maturities, equity securities and certain other invested assets are reported as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are included as a separate component of stockholders' equity as accumulated other comprehensive income and as such are not included in the determination of net income.

We have investment policy guidelines with respect to purchasing fixed maturity investments for our insurance subsidiaries which preclude investments in bonds that are rated below investment grade, at the time of purchase, by a recognized rating service. Our fixed maturity portfolio is composed of high quality, investment grade issues, comprised almost entirely of debt issues rated AAA, AA or A. We obtain investment ratings from Moody's, Standard & Poor's and Fitch. If there is a split rating, we assign the lowest rating obtained. At June 30, 2015, there were no fixed maturity investments rated below investment grade in our available-for-sale investment portfolio. For further discussion regarding the management of our investment portfolio, see "Management's Discussion and Analysis of Financial Condition and Results of Operations – Results of Operations – Investment Operations Segment" in Item 7 of the 2014 Form 10-K.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Composition of Investment Portfolio

The following table sets forth the composition of our investment portfolio at carrying value at June 30, 2015 and December 31, 2014:

(\$ millions)	June 30, 2015	% of Total	December 31, 2014	% of Total
Cash and cash equivalents	\$50.6	2.1	\$86.3	3.5
Fixed maturities, at fair value:				
Fixed maturities	1,771.3	71.7	1,680.0	68.7
Treasury inflation-protected securities	187.8	7.6	211.9	8.7
Total fixed maturities	1,959.1	79.3	1,891.9	77.4
Notes receivable from affiliate <sup>(a)</sup>	70.0	2.8	70.0	2.9
Equity securities, at fair value:				
Large-cap securities	224.8	9.1	242.2	9.9
Small-cap securities	72.6	2.9	68.2	2.8
Total equity securities	297.4	12.0	310.4	12.7
Other invested assets, at fair value:				
International funds	81.1	3.3	72.9	3.0
Other invested assets	8.2	0.3	7.4	0.3
Total other invested assets, at fair value	89.3	3.6	80.3	3.3
Other invested assets, at cost	5.3	0.2	5.3	0.2
Total portfolio	\$2,471.7	100.0	\$2,444.2	100.0

In May 2009, we entered into two separate Credit Agreements with State Auto Mutual. Under these (a) Credit Agreements, State Auto Mutual borrowed a total of \$70.0 million from us on an unsecured basis.

Interest is payable semi-annually at a fixed annual interest rate of 7.00%. Principal is payable May 2019.

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at June 30, 2015:

(\$ millions)	Amortized cost	Fair value
Due in 1 year or less	\$35.3	\$35.9
Due after 1 year through 5 years	355.2	367.0
Due after 5 years through 10 years	304.3	313.4
Due after 10 years	765.8	767.9
U.S. government agencies mortgage-backed securities	466.5	474.9
Total	\$1,927.1	\$1,959.1

Expected maturities may differ from contractual maturities as the issuers may have the right to call or prepay the obligations with or without call or prepayment penalties. The duration of the fixed maturity portfolio was approximately 5.41 and 4.32 as of June 30, 2015 and December 31, 2014, respectively.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Investment Operations Revenue

The following table sets forth the components of net investment income for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended		Six months ended	
	June 30		June 30	
	2015	2014	2015	2014
Gross investment income:				
Fixed maturities	\$ 17.4	\$ 17.9	\$ 30.3	\$ 33.3
Equity securities	1.7	1.7	3.3	3.1
Other	1.3	1.4	2.7	2.7
Total gross investment income	20.4	21.0	36.3	39.1
Less: Investment expenses	0.6	0.5	1.1	1.0
Net investment income	\$ 19.8	\$ 20.5	\$ 35.2	\$ 38.1
Average invested assets (at cost)	\$ 2,273.2	\$ 2,139.2	\$ 2,246.2	\$ 2,134.8
Annualized investment yield	3.5	% 3.8	% 3.1	% 3.6
Annualized investment yield, after tax	2.7	% 2.9	% 2.4	% 2.7
Net investment income, after tax	\$ 15.1	\$ 15.4	\$ 27.3	\$ 28.9
Effective tax rate	23.7	% 25.0	% 22.3	% 24.0

The following table sets forth realized gains and the proceeds received on sale for our investment portfolio for the three and six months ended June 30, 2015 and 2014:

(\$ in millions)	Three months ended June 30				Six months ended June 30			
	2015		2014		2015		2014	
	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale
Realized gains:								
Fixed maturities	\$0.4	\$ 6.4	\$0.4	\$ 30.5	\$ 1.5	\$ 68.9	\$ 2.5	\$ 101.8
Equity securities	5.9	16.1	5.2	29.5	10.0	35.1	14.7	62.6
Other invested assets	0.1	0.2	—	—	0.1	0.3	0.1	0.1
Total realized gains	6.4	22.7	5.6	60.0	11.6	104.3	17.3	164.5
Realized losses:								
Equity securities:								
Sales	(0.2 )	2.2	—	0.7	(0.7 )	4.7	(0.1 )	2.3
OTTI	(0.8 )	—	(0.3 )	—	(1.3 )	—	(1.2 )	—
Total realized losses	(1.0 )	2.2	(0.3 )	0.7	(2.0 )	4.7	(1.3 )	2.3
Net realized gain on investments	\$ 5.4	\$ 24.9	\$ 5.3	\$ 60.7	\$ 9.6	\$ 109.0	\$ 16.0	\$ 166.8

During the first six months of 2015, equity sales were executed for various reasons, including: (i) the achievement of our price target; (ii) in response to changes in business conditions, which in our opinion diminished the future business prospects on these securities; and (iii) in order to manage our equity holdings consistent with our investment guidelines.

When a fixed maturity security has been determined to have an other-than-temporary decline in fair value, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income. See



“Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies – Investments” included in Item 7 of the 2014 Form 10-K for other-than-temporary impairment (“OTTI”) indicators. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income. We did not recognize OTTI on our fixed maturity portfolio for the three and six months ended June 30, 2015 and 2014.

45

---

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

When an equity security or other invested asset has been determined to have a decline in fair value that is other-than-temporary, we adjust the cost basis of the security to fair value. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies – Investments” included in Item 7 of the 2014 Form 10-K for OTTI impairment indicators. This results in a charge to earnings as a realized loss, which is not reversed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income.

The following table sets forth the realized losses related to OTTI on our investment portfolio recognized for the three and six months ended June 30, 2015:

(\$ millions, except # of positions)	Three months ended June 30		Six months ended June 30	
	Number of positions	Total impairment	Number of positions	Total impairment
Equity securities:				
Small-cap securities	7	\$(0.8	) 14	\$(1.3

## Gross Unrealized Investment Gains and Losses

Based upon our review of our investment portfolio at June 30, 2015, we determined that there were no individual investments with an unrealized holding loss that had a fair value significantly below cost continually for more than one year. The following table sets forth detailed information on our available-for-sale investment portfolio by lot at fair value for our gross unrealized holding gains (losses) at June 30, 2015:

(\$ millions, except # of positions)	Cost or amortized cost	Gross unrealized holding gains	Number of gain positions	Gross unrealized holding losses	Number of loss positions	Fair value
Fixed maturities:						
U.S. treasury securities and obligations of U.S. government agencies	\$274.5	\$ 13.3	27	\$(2.7	) 17	\$285.1
Obligations of states and political subdivisions	844.5	17.5	191	(8.6	) 63	853.4
Corporate securities	341.6	7.8	57	(3.7	) 21	345.7
U.S. government agencies mortgage-backed securities	466.5	13.0	70	(4.6	) 29	474.9
Total fixed maturities	1,927.1	51.6	345	(19.6	) 130	1,959.1
Equity securities:						
Large-cap securities	177.2	48.9	27	(1.3	) 3	224.8
Small-cap securities	52.8	19.8	70	—	—	72.6
Total equity securities	230.0	68.7	97	(1.3	) 3	297.4
Other invested assets	54.6	34.7	3	—	—	89.3
Total available-for-sale investments	\$2,211.7	\$ 155.0	445	\$(20.9	) 133	\$2,345.8

The following table sets forth our unrealized holding gains by investment type, net of deferred tax that was included as a component of accumulated other comprehensive income at June 30, 2015 and December 31, 2014, and the change in unrealized holding gains, net of deferred tax, for the six months ended June 30, 2015:

(\$ millions)	June 30, 2015	December 31, 2014	\$ Change
Available-for-sale investments:			

Unrealized holding gains:			
Fixed maturities	\$ 32.0	\$ 60.6	\$(28.6 )
Equity securities	67.4	74.9	(7.5 )
Other invested assets	34.7	29.8	4.9
Unrealized gains	134.1	165.3	(31.2 )
Net deferred federal income tax liability	(44.4 )	(55.3 )	10.9
Unrealized gains, net of tax	\$ 89.7	\$ 110.0	\$(20.3 )

#### Fair Value Measurements

We primarily use one independent nationally recognized pricing service in developing fair value estimates. We obtain one price per security, and our processes and control procedures are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, we gain an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, we compare to other fair value pricing information gathered from other independent pricing sources. See Note 3, "Fair Value of Financial Instruments" to our condensed consolidated financial statements included in Item 1 of this Form 10-Q for a presentation of our available-for-sale investments within the fair value hierarchy at June 30, 2015 and December 31, 2014.

As of June 30, 2015, Level 3 assets as a percentage of total assets were 0.1% which we have determined to be insignificant.

Table of Contents

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Other Items

## Income Taxes

The following table sets forth the components of our federal income tax expense for the three and six months ended June 30, 2015 and 2014, respectively.

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Income before federal income taxes	\$3.4	\$3.1	\$36.6	\$30.8
Current tax expense	0.2	0.1	0.6	0.7
Deferred tax expense (benefit)	0.5	(0.4)	) 8.6	6.8
	0.7	(0.3)	) 9.2	7.5
Valuation allowance	—	0.4	—	(6.8)
Total federal income tax expense	0.7	0.1	9.2	0.7
Net income	\$2.7	\$3.0	\$27.4	\$30.1

For the three and six months ended June 30, 2015, we recorded current federal income tax expense of \$0.2 million and \$0.6 million, respectively, compared to \$0.1 million and \$0.7 million for the same 2014 periods. The federal income tax expense for the three and six months ended June 30, 2014 consisted of Alternative Minimum Tax ("AMT"), an alternative tax system. On a quarterly basis, we calculate AMT and, if it is greater than our federal income tax, we provide for the AMT. We had both federal income tax and AMT net operating loss ("NOL") carryforwards at June 30, 2015 and 2014. However, the Internal Revenue Code only permits a 90% offset of the AMT obligation, compared to a 100% offset of the federal income tax obligation. The disallowed utilization of the 10% portion of the AMT NOL resulted in our current federal income tax expense for the three and six months ended June 30, 2014.

Deferred tax expense for the three and six months ended June 30, 2015 was \$0.5 million and \$8.6 million, respectively, compared to a deferred income tax benefit of \$0.4 million and deferred tax expense of \$6.8 million for the same 2014 periods. The deferred tax expense for both periods was primarily attributable to the utilization of NOL carryforwards. The deferred tax benefit for the quarter ended June 30, 2014 and expense for the six months ended June 30, 2014 were offset by a change in the valuation allowance against net deferred federal income taxes.

Effective tax rates were 20.0% and 3.0% for the three months ended June 30, 2015 and 2014, respectively, and 25.0% and 2.0% for the six months ended June 30, 2015 and 2014, respectively. See Note 5 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

LIQUIDITY AND CAPITAL RESOURCES

General

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

Liquidity

Our insurance subsidiaries must have adequate liquidity to ensure that their cash obligations are met. However, as discussed below, the STFC Pooled Companies do not have the day-to-day liquidity concerns normally associated with an insurance company due to their participation in, and the terms of, the Pooling Arrangement. In addition, State Auto P&C's \$100.0 million credit facility is available for general corporate purposes such as funding liquidity needs. See "Borrowing Arrangements - Credit Facility" included in this Item 2.

Under the terms of the Pooling Arrangement, State Auto Mutual receives all premiums and pays all losses and expenses associated with the insurance business produced by the STFC Pooled Companies and the other pool participants, and then it settles the intercompany balances generated by these transactions with the pool participants within 60 days following each quarter end. We believe this provides State Auto Mutual with sufficient liquidity to pay losses and expenses of our insurance operations on a timely basis. When settling the intercompany balances, State Auto Mutual provides the pool participants with full credit for the premiums written net of losses paid during the quarter, retaining all receivable amounts from insureds and agents and reinsurance recoverable on paid losses from unaffiliated reinsurers. Any receivable amounts that are ultimately deemed to be uncollectible are charged-off by State Auto Mutual and allocated to the pool participant on the basis of its pooling percentage.

As a result of the Pooling Arrangement, we have an off-balance sheet credit risk related to the balances due to State Auto Mutual from insureds, agents and reinsurers, which are offset by the unearned premiums from the respective policies. While the total amount due to State Auto Mutual from policyholders and agents is significant, the individual amounts due are relatively small at the policyholder and agency level. Based on historical data, this credit risk exposure is not considered to be material to our financial position, though the impact to income on a quarterly basis may be material. The State Auto Group mitigates its exposure to this credit risk through its in-house collections unit for both personal and commercial accounts which is supplemented by third party collection service providers. The amounts deemed uncollectible by State Auto Mutual and allocated to the STFC Pooled Companies are included in the other expenses line item in the accompanying consolidated statements of income.

We generally manage our cash flows through current operational activity and maturing investments, without a need to liquidate any of our other investments; however, should our written premiums decline or paid losses increase significantly, or a combination thereof, we may need to liquidate investments at losses in order to meet our cash obligations. This action was not necessary for the three and six months ended June 30, 2015.

We maintain a portion of our investment portfolio in relatively short-term and highly liquid investments to ensure the immediate availability of funds to pay claims and expenses. At June 30, 2015 and December 31, 2014, we had \$50.6 million and \$86.3 million, respectively, in cash and cash equivalents, and \$2,345.8 million and \$2,282.6 million, respectively, of total available-for-sale investments. Our fixed maturities available-for-sale included \$8.9 million and \$8.8 million of securities on deposit with insurance regulators as required by law at June 30, 2015 and December 31, 2014; in addition, substantially all of our fixed maturity and equity securities are traded on public markets. For a further discussion regarding investments, see "Investments Operations Segment" included in this Item 2.

Net cash provided by operating activities was \$62.3 million and \$4.8 million for the six months ended June 30, 2015 and 2014, respectively. The increase in net cash provided by operating activities was due to the expiration of the HO QS Arrangement at December 31, 2014, which resulted in STFC receiving a return of \$63.5 million of premiums. Net cash from operations will vary from period to period if there are significant changes in underwriting results, primarily a combination of the level of premiums written and loss and loss expenses paid, changes in cash flows from investment income or federal income tax activity.

48

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Net cash used in investing activities was \$91.9 million and \$7.3 million for the six months ended June 30, 2015 and 2014, respectively. The change was primarily driven by the reinvestment of the premiums received from the expiration of the HO QS Arrangement.

Net cash used in financing activities was \$6.1 million and \$6.3 million for the six months ended June 30, 2015 and 2014, respectively.

**Borrowing Arrangements**

**Credit Facility**

State Auto P&C has a \$100.0 million five-year revolving credit facility (the "Credit Facility") maturing in July 2018 with a syndicate of lenders. During the term of the Credit Facility, State Auto P&C has the right to increase the total facility to a maximum amount of \$150.0 million, provided that no event of default has occurred and is continuing. The Credit Facility is available for general corporate purposes and provides for interest-only payments during its term, with principal and interest due in full at maturity. Interest is based on LIBOR or a base rate plus a calculated margin amount. All advances under the Credit Facility are to be fully secured by a pledge of specific investment securities of State Auto P&C. The Credit Facility includes certain covenants and requirements, including financial requirements that State Auto Financial maintain a minimum net worth and a certain debt to capitalization ratio. As of June 30, 2015, State Auto P&C had not made any borrowings under the Credit Facility and State Auto P&C and State Auto Financial were in compliance with all covenants and requirements of the Credit Facility.

**FHLB Loan**

State Auto P&C has outstanding an \$85.0 million loan ("FHLB loan") from the Federal Home Loan Bank of Cincinnati. The FHLB Loan is a 20-year term loan, callable after three years with no prepayment penalty thereafter. The FHLB Loan provides for interest-only payments during its term, with principal due in full at maturity. The interest rate is fixed over the term of the loan at 5.03%. The FHLB Loan is fully secured by a pledge of specific investment securities of State Auto P&C.

**Subordinated Debentures**

State Auto Financial's Delaware business trust subsidiary (the "Capital Trust") has outstanding \$15.0 million liquidation amount of capital securities, due 2033. In connection with the Capital Trust's issuance of the capital securities and the related purchase by State Auto Financial of all of the Capital Trust's common securities (liquidation amount of \$0.5 million), State Auto Financial has issued to the Capital Trust \$15.5 million aggregate principal amount of unsecured Floating Rate Junior Subordinated Debt Securities due 2033 (the "Subordinated Debentures"). The sole assets of the Capital Trust are the Subordinated Debentures and any interest accrued thereon. Interest on the Capital Trust's capital and common securities is payable quarterly at a rate equal to the three-month LIBOR rate plus 4.20%, adjusted quarterly. The applicable interest rates for June 30, 2015 and 2014 were 4.48% and 4.44%, respectively.

**Reinsurance Arrangements**

Members of the State Auto Group follow the customary industry practice of reinsuring a portion of their exposures and paying to the reinsurers a portion of the premiums received. Insurance is ceded principally to reduce net liability on individual risks or for individual loss occurrences, including catastrophic losses. Although reinsurance does not legally discharge the individual members of the State Auto Group from primary liability for the full amount of limits applicable under their policies, it does make the assuming reinsurer liable to the extent of the reinsurance ceded. To minimize the risk of reinsurer default, the State Auto Group cedes only to third-party reinsurers who are rated A- or better by A.M. Best or Standard & Poor's and also utilizes both domestic and international markets to diversify its credit risk. We utilize reinsurance to limit our loss exposure and contribute to our liquidity and capital resources. Each member of the State Auto Group is party to working reinsurance treaties for casualty, workers' compensation and property lines with several reinsurers arranged through reinsurance intermediaries. These agreements are described in more detail below. We have also secured other reinsurance to limit the net cost of large loss events for certain types of coverage. The State Auto Group also makes use of facultative reinsurance for unique risk situations. The State Auto Group also participates in state insurance pools and associations. In general, these pools and associations are state

sponsored and/or operated, impose mandatory participation by insurers doing business in that state, and offer coverage for hard-to-place risks at premium rates established by the state sponsor or operator, thereby transferring risk of loss to the participating insurers in exchange for premiums which may not be commensurate with the risk assumed.

49

---



Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Property Catastrophe

Members of the State Auto Group maintain a property catastrophe excess of loss reinsurance agreement, covering property catastrophe related events affecting at least two risks. As of June 1, 2015, this property catastrophe reinsurance agreement renewed. Under this agreement, the State Auto Group retains the first \$55.0 million of catastrophe loss, each occurrence, with a 5.0% co-participation on the next \$285.0 million of covered loss, each occurrence. The reinsurers are responsible for 95% of the excess over \$55.0 million up to \$340.0 million of covered losses, each occurrence. Under this agreement, our companies are responsible for losses above \$340.0 million. The State Auto Group also maintains a separate property catastrophe excess of loss reinsurance agreement covering Excess & Surplus property and Programs catastrophe related events affecting at least two risks. Under this agreement, the State Auto Group retains the first \$15.0 million of catastrophe loss, each occurrence, with a 15% co-participation on the next \$40.0 million of covered loss, each occurrence. The reinsurers are responsible for 85% of the excess over \$15.0 million up to \$55.0 million of covered loss, each occurrence.

The rates for this reinsurance agreement are negotiated annually.

Property Per Risk

At June 1, 2015, the State Auto Group renewed the property per risk excess of loss reinsurance agreement. This reinsurance agreement provides that the State Auto Group is responsible for the first \$1.0 million of each covered loss for E&S property and Programs units, and the first \$3.0 million of each covered loss for other property business. The State Auto Group is also responsible for an additional \$2.0 million in aggregate retention per treaty year for losses exceeding \$3.0 million. The reinsurers are responsible for 75% of the loss in excess of \$1.0 million for the E&S property and Programs units and 100% of the loss excess of \$3.0 million for other property business up to \$20.0 million of covered loss.

The rates for this reinsurance agreement are negotiated annually.

Casualty and Workers' Compensation

As of July 1, 2015, the State Auto Group renewed our casualty excess of loss reinsurance agreement. Under this agreement, the State Auto Group is responsible for the first \$1.0 million of workers' compensation losses, each loss occurrence, subject to an additional \$1.0 million in annual aggregate retention, and \$2.0 million of losses that involve auto liability, other liability and umbrella liability policies, subject to an additional \$2.0 million in annual aggregate retention. The reinsurance agreement provides coverage up to \$10.0 million, except for umbrella policies which are covered for limits up to \$15.0 million. E&S casualty and Programs units risks are not subject to this casualty excess of loss reinsurance agreement.

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

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

For E&S casualty and Programs unit risks, the State Auto Group has a combined casualty treaty whereby under Section A, we retain the first \$1.0 million of covered loss and the reinsurers are responsible for 90.0% of loss in

excess of \$1.0 million up to \$10.0 million for all primary business with policy limits issued greater than \$1.0 million. A separate retention of \$1.0 million applies to lead excess business (excess business written directly above a primary policy), and the reinsurers are responsible for 90.0% of loss in excess of \$1.0 million up to \$10.0 million. For lead excess business to be ceded to Section A the excess limits issued must be greater than \$1.0 million. Under Section B, as respects non-lead excess policies, we have a \$10.0 million proportional agreement where we retain \$1.0 million of each risk and the reinsurers are responsible for 90.0% of loss for each risk based on

50

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

the percentage the \$1.0 million we retain bears to the total policy limit. Also under Section B, if we write a non-lead excess policy and also write the primary policy for the same insured, there is a separate \$1.0 million retention for the primary policy. Under Section C, with respect to policies at \$1.0 million or less, we retain the first \$1.25 million of Extra Contractual Obligations/Excess of Policy Limits ("ECO/XPL") and LAE coverage for policies with limits of \$1.0 million or less, and the reinsurers are responsible for 90% of ECO/XPL and LAE coverage in excess of \$1.25 million up to \$4.0 million.

The rates for these reinsurance agreements are negotiated annually.

For a discussion of our other reinsurance arrangements see "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources – Reinsurance Arrangements" in Item 7 of the 2014 Form 10-K.

Regulatory Considerations

At June 30, 2015, all of our insurance subsidiaries were in compliance with statutory requirements relating to capital adequacy.

ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS

None.

CREDIT AND FINANCIAL STRENGTH RATINGS

On April 28, 2015, A.M. Best revised the State Auto Group's financial strength rating to A- (Excellent) with a stable outlook from A (Excellent) with a negative outlook.

On April 16, 2015, Standard & Poor's revised the Company's credit rating to BB+ with a stable outlook from BB+ with a negative outlook.

MARKET RISK

With respect to Market Risk, see the discussion regarding this subject at "Management's Discussion and Analysis of Financial Condition and Results of Operations – Investment Operations Segment – Market Risk" in Item 7 of the 2014 Form 10-K. There have been no material changes from the information reported regarding Market Risk in the 2014 Form 10-K.

Item 3. Quantitative and Qualitative Disclosure of Market Risk

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

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Item 4. Controls and Procedures

Disclosure Controls and Procedures

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

Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, 1. processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission;

Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is 2. accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure; and

3. Our disclosure controls and procedures are effective in timely making known to them material information required to be included in our periodic filings with the Securities and Exchange Commission.

Changes in Internal Control over Financial Reporting

There has been no change in our internal controls over financial reporting that occurred during the most recent fiscal quarter that has materially affected, nor is it likely to materially affect, our internal control over financial reporting.

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in the 2014 Form 10-K under Part I, Item 1A – Risk Factors.

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

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

53

---

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Item 6. Exhibits

Exhibit No.	Description of Exhibits
10.01	Management and Operations Agreement Amended and Restated as of January 1, 2015, by and among State Automobile Mutual Insurance Company, State Auto Financial Corporation, State Auto Property & Casualty Insurance Company, State Auto Insurance Company of Ohio, Milbank Insurance Company, Meridian Security Insurance Company, Patrons Mutual Insurance Company of Connecticut, Stateco Financial Services, Inc., 518 Property Management and Leasing, LLC, State Auto Holdings, Inc., Facilitators, Inc., CDC Holding, Inc., Partners General Insurance Agency, LLC, and Network E&S Insurance Brokers, LLC.
31.01	CEO certification required by Section 302 of Sarbanes Oxley Act of 2002
31.02	CFO certification required by Section 302 of Sarbanes Oxley Act of 2002
32.01	CEO certification required by Section 906 of Sarbanes Oxley Act of 2002
32.02	CFO certification required by Section 906 of Sarbanes Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

SIGNATURE

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

Date: August 5, 2015

State Auto Financial Corporation

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