State Auto Financial CORP
Form 10-Q
May 05, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2010

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 x No ¨

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

Yes ¨ No ¨

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

Large accelerated file ¨	Accelerated filer x	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 x

On April 30, 2010, the Registrant had 39,946,987 Common Shares outstanding.

Table of Contents

Index to Form 10-Q Quarterly Report for the three month period ended March 31, 2010

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

($ millions, except per share amount)	**March 31 2010** (unaudited)	December 31 2009 (see note 1)
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost $1,771.6 and $1,788.1, respectively)	**$ 1,817.0**	1,831.8
Equity securities, available-for-sale, at fair value (cost $220.7 and $189.7, respectively)	**260.6**	224.1
Other invested assets, available-for-sale, at fair value (cost $52.1and $44.1, respectively)	**61.4**	52.3
Other invested assets	**1.0**	0.9
Note receivable from affiliate	**70.0**	70.0
Total investments	**2,210.0**	2,179.1
Cash and cash equivalents	**80.1**	90.3
Accrued investment income and other assets	**25.6**	35.1
Deferred policy acquisition costs	**127.9**	127.3
Reinsurance recoverable on losses and loss expenses payable (affiliates $0.0 and $0.1, respectively)	**19.7**	20.8
Prepaid reinsurance premiums (affiliates none)	**14.3**	7.2
Due from affiliate	**7.4**	7.7
Current federal income taxes	**7.9**	9.1
Net deferred federal income taxes	**69.0**	75.9
Property and equipment, at cost	**11.9**	12.0
Total assets	**$ 2,573.8**	2,564.5
Liabilities and Stockholders Equity		
Losses and loss expenses payable (affiliates $341.6 and $346.2, respectively)	**$ 841.6**	840.2
Unearned premiums (affiliates $180.1 and $180.7, respectively)	**547.2**	547.0
Notes payable (affiliates $15.5 and $15.5, respectively)	**117.1**	117.2
Postretirement and pension benefits	**153.9**	150.4
Other liabilities	**50.5**	60.3
Total liabilities	**1,710.3**	1,715.1
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; 46.7 and 46.6 shares issued, respectively, at stated value of $2.50 per share	**116.7**	116.6
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	**(115.7)**	(115.7)
Additional paid-in capital	**117.1**	115.8
Accumulated other comprehensive income (loss)	**2.8**	(2.9)
Retained earnings	**742.6**	735.6
Total stockholders equity	**863.5**	849.4
Total liabilities and stockholders equity	**$ 2,573.8**	2,564.5

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 Income

($ millions, except per share amounts)	Three months ended March 31	
(unaudited)	**2010**	2009
Earned premiums (ceded to affiliates $201.7 and $179.9, respectively)	**$ 302.3**	286.0
Net investment income (affiliates $1.2 in 2010)	**20.5**	18.3
Net realized gain (loss) on investments:		
Total other-than-temporary impairment losses	**(0.8)**	(6.4)
Portion of loss recognized in other comprehensive income		
Other net realized investment gains (losses)	**4.0**	(4.9)
Total net realized gain (loss) on investments	**3.2**	(11.3)
Other income (affiliates $0.5 and $0.7, respectively)	**0.4**	1.0
Total revenues	**326.4**	294.0
Losses and loss expenses (ceded to affiliates $134.1 and $139.7, respectively)	**200.0**	224.8
Acquisition and operating expenses	**101.2**	95.4
Interest expense (affiliates $0.2 and $0.2, respectively)	**1.8**	2.0
Other expenses	**2.8**	2.7
Total expenses	**305.8**	324.9
Income (loss) before federal income taxes	**20.6**	(30.9)
Federal income tax expense (benefit)	**7.7**	(16.9)
Net income (loss)	**$ 12.9**	(14.0)
Earnings (loss) per common share:		
Basic	**$ 0.32**	(0.35)
Diluted	**$ 0.32**	(0.35)
Dividends paid per common share	**$ 0.15**	0.15

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

($ millions) (unaudited)	Three months ended March 31 **2010**	2009
Cash flows from operating activities:		
Net income (loss)	**$ 12.9**	(14.0)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization, net	**2.2**	4.9
Share-based compensation	**0.6**	0.7
Net realized (gain) loss on investments	**(3.2)**	11.3
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	**(0.9)**	(0.1)
Accrued investment income and other assets	**(0.1)**	(0.7)
Postretirement and pension benefits	**3.9**	(0.5)
Other liabilities and due to/from affiliates, net	**(16.7)**	(27.3)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	**0.8**	2.3
Losses and loss expenses payable	**5.4**	20.3
Unearned premiums	**1.6**	1.5
Excess tax benefits on share based awards	**0.1**	
Federal income taxes	**5.1**	(16.8)
Cash provided from pooling change, January 1, 2010 (Note 4)	**3.7**	
Net cash provided by (used in) operating activities	**15.4**	(18.4)
Cash flows from investing activities:		
Purchases of fixed maturities available-for-sale	**(87.9)**	(79.8)
Purchases of equity securities available-for-sale	**(47.0)**	(2.0)
Purchases of other invested assets	**(8.3)**	(0.3)
Maturities, calls and pay downs of fixed maturities available-for-sale	**66.4**	28.2
Sales of fixed maturities available-for-sale	**36.8**	65.9
Sales of equity securities available-for-sale	**19.5**	9.3
Sales of other invested assets	**0.3**	0.1
Net cash (used in) provided by investing activities	**(20.2)**	21.4
Cash flows from financing activities:		
Proceeds from issuance of common stock	**0.5**	0.1
Payment of dividends	**(5.9)**	(5.9)
Net cash used in financing activities	**(5.4)**	(5.8)

Net decrease in cash and cash equivalents	**(10.2)**	(2.8)
Cash and cash equivalents at beginning of period	**90.3**	150.5
Cash and cash equivalents at end of period	**$ 80.1**	147.7
Supplemental disclosures:		
Interest paid (affiliates $0.2 and $0.2, respectively)	**$ 0.2**	0.2
Federal income taxes paid (received)	**$ 2.5**	(0.1)

See accompanying notes to condensed consolidated financial statements.

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, (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries (State Auto Financial or the Company) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. The balance sheet at December 31, 2009 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, 2009 (the 2009 Form 10-K). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2009 Form 10-K.

Adoption of Recent Accounting Pronouncements

Amendments to Accounting for Variable Interest Entities

In June 2009, the Financial Accounting Standards Board (FASB) issued revised guidance on the accounting for variable interest entities. The revised guidance, which was issued as Statement of Financial Accounting Standards (SFAS) No. 167, *Amendments to FASB Interpretation No. 46(R)*, is included in the Consolidation Topic of the FASB Accounting Standards Codification (ASC). The revised guidance eliminates the concept of a qualifying special-purpose entity and replaces the quantitative-based risks and rewards calculation of the previous guidance for determining which company, if any, has a controlling financial interest in a variable interest entity. The revised guidance requires an analysis of whether a company has: (1) the power to direct the activities of a variable interest entity that most significantly impact the entity s economic performance and (2) the obligation to absorb the losses that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity. An entity is required to be re-evaluated as a variable interest entity when the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights to direct the activities that most significantly impact the entity s economic performance. Additional disclosures are required about a company s involvement in variable interest entities and an ongoing assessment of whether a company is the primary beneficiary. The adoption of the new guidance effective January 1, 2010 had no effect on the Company s consolidated financial statements.

Improving Disclosures about Fair Value Measurements

In January 2010, the FASB issued guidance to improve the disclosures related to fair value measurements. The new guidance requires expanded fair value disclosures, including the reasons for significant transfers between Level 1 and Level 2 and the amount of significant transfers into each level disclosed separately from transfers out of each level. For Level 3 fair value measurements, information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements shall be presented separately on a gross basis, rather than as one net number. In addition, clarification is provided about existing disclosure requirements, such as presenting fair value measurement disclosures for each *class* of assets and liabilities that are determined based on their nature and risk characteristics and their placement in the fair value hierarchy (that is, Level 1, 2, or 3), as opposed to each *major category* of assets and liabilities, as required in the previous guidance. Disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements are required for fair value measurement that fall in either Level 2 or Level 3. The Company adopted this new guidance effective January 1, 2010, except for the gross presentation of purchases, sales, issuances and settlements in the Level 3 reconciliation, which is effective for annual and interim reporting periods beginning after December 15, 2010. The disclosures required by this new guidance are provided in the accompanying Note 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)

2. Investments

The following tables summarize the cost or amortized cost and fair value of available-for-sale securities at March 31, 2010 and December 31, 2009:

($ millions) **At March 31, 2010:**	**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	**$ 388.2**	**6.6**	**(0.8)**	**394.0**
Obligations of states and political subdivisions	**988.0**	**31.3**	**(1.6)**	**1,017.7**
Corporate securities	**107.7**	**3.3**	**(0.1)**	**110.9**
U.S. government agencies residential mortgage-backed securities	**287.7**	**7.5**	**(0.8)**	**294.4**
Total fixed maturities	**1,771.6**	**48.7**	**(3.3)**	**1,817.0**
Equity securities:				
Large-cap equity securities	**189.3**	**36.4**	**(1.1)**	**224.6**
Small-cap equity securities	**31.4**	**4.6**		**36.0**
Total equity securities	**220.7**	**41.0**	**(1.1)**	**260.6**
Other invested assets	**52.1**	**9.3**		**61.4**
Total available-for-sale securities	**$ 2,044.4**	**99.0**	**(4.4)**	**2,139.0**

($ millions) At December 31, 2009:	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	$ 348.4	5.9	(1.4)	352.9
Obligations of states and political subdivisions	1,046.9	33.2	(1.5)	1,078.6
Corporate securities	97.4	2.4	(0.1)	99.7
U.S. government agencies residential mortgage-backed securities	295.4	6.4	(1.2)	300.6
Total fixed maturities	1,788.1	47.9	(4.2)	1,831.8
Equity securities:				
Large-cap equity securities	164.7	31.6	(0.2)	196.1
Small-cap equity securities	25.0	3.0		28.0

Total equity securities	189.7	34.6	(0.2)	224.1
Other invested assets	44.1	8.2		52.3
Total available-for-sale securities	$ 2,021.9	90.7	(4.4)	2,108.2

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)

The following tables reflect the Company s gross unrealized losses and fair value on its investments, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at March 31, 2010 and December 31, 2009:

($ millions, except # of positions)	**Less than 12 months**			**12 months or more**			**Total**		
At March 31, 2010:	**Fair value**	**Unrealized losses**	**Number of positions**	**Fair value**	**Unrealized losses**	**Number of positions**	**Fair value**	**Unrealized losses**	**Number of positions**
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	**$ 92.7**	**$ (0.8)**	**36**	**$**	**$**		**$ 92.7**	**$ (0.8)**	**36**
Obligations of states and political subdivisions	**114.8**	**(1.2)**	**44**	**18.2**	**(0.4)**	**7**	**133.0**	**(1.6)**	**51**
Corporate securities	**12.5**	**(0.1)**	**7**				**12.5**	**(0.1)**	**7**
U.S. government agencies residential mortgage-backed securities	**32.6**	**(0.2)**	**7**	**22.0**	**(0.6)**	**12**	**54.6**	**(0.8)**	**19**
Total fixed maturities	**252.6**	**(2.3)**	**94**	**40.2**	**(1.0)**	**19**	**292.8**	**(3.3)**	**113**
Large-cap equity securities	**38.4**	**(1.1)**	**13**				**38.4**	**(1.1)**	**13**
Total temporarily impaired securities	**$ 291.0**	**$ (3.4)**	**107**	**$ 40.2**	**$ (1.0)**	**19**	**$ 331.2**	**$ (4.4)**	**126**

($ millions, except # of positions)	Less than 12 months			12 months or more			Total		
At December 31, 2009:	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	$ 121.9	$ (1.4)	53	$	$		$ 121.9	$ (1.4)	53
Obligations of states and political subdivisions	92.6	(1.0)	39	26.0	(0.5)	9	118.6	(1.5)	48
Corporate securities	15.5	(0.1)	10				15.5	(0.1)	10
U.S. government agencies residential mortgage-backed securities	52.8	(0.4)	14	22.0	(0.8)	11	74.8	(1.2)	25

Total fixed maturities	282.8	(2.9)	116	48.0	(1.3)	20	330.8	(4.2)	136
Large-cap equity securities	14.9	(0.2)	6				14.9	(0.2)	6
Total temporarily impaired securities	$ 297.7	$ (3.1)	122	$ 48.0	$ (1.3)	20	$ 345.7	$ (4.4)	142

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Realized losses recognized for the three months ended March 31 related to other-than-temporary impairments on the Company s investment portfolio are summarized as follows:

($ millions)	Three months ended March 31	
	2010	2009
Equity securities:		
Large-cap equity securities	**$ 0.3**	5.6
Small-cap equity securities	**0.5**	0.8
Total other-than-temporary impairments	**$ 0.8**	6.4

The Company did not recognize other-than-temporary impairments on its fixed maturity securities for the three months ended March 31, 2010 and 2009. The Company reviewed its investments at March 31, 2010 and 2009, and determined no additional other-than-temporary impairment existed in the gross unrealized holding losses.

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

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

The amortized cost and fair value of available-for-sale fixed maturities at March 31, 2010, by contractual maturity, are as follows:

($ millions)	Amortized cost	Fair value
Due in 1 year or less	**$ 15.3**	**15.4**

Due after 1 year through 5 years	**273.9**	**280.5**
Due after 5 years through 10 years	**507.2**	**525.2**
Due after 10 years	**687.5**	**701.5**
U.S. government agencies residential mortgage-backed securities	**287.7**	**294.4**
Total	**$ 1,771.6**	**1,817.0**

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

Fixed maturities with fair values of $63.0 million and $56.9 million were on deposit with insurance regulators as required by law at March 31, 2010 and December 31, 2009, respectively.

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)

Components of net investment income for the three months ended March 31 are summarized as follows:

($ millions)	Three months ended March 31	
	2010	2009
Fixed maturities	**$ 18.5**	17.0
Equity securities	**1.1**	1.0
Cash and cash equivalents, and other	**1.5**	0.8
Investment income	**21.1**	18.8
Investment expenses	**0.6**	0.5
Net investment income	**$ 20.5**	18.3

The Company s current investment strategy does not rely on the use of derivative financial instruments. See Note 3 for additional fair value disclosures.

Proceeds on sales of available-for-sale securities for the three months ended March 31, 2010 and 2009, were $56.3 million and $86.8 million, respectively.

The unrealized holding gains and losses, net of applicable deferred federal income taxes, are shown as a separate component of stockholders equity as a part of accumulated other comprehensive income (loss) and, as such, are not included in the determination of net income (loss). Realized gains and losses on the sales of investments are computed using the first-in, first-out method.

Realized and unrealized holding gains and losses for the three months ended March 31 are summarized as follows:

($ millions)	Three months ended March 31	
	2010	2009
Realized gains:		
Fixed maturities	**$ 0.9**	0.9
Equity securities	**3.9**	0.1
Total realized gains	**4.8**	1.0
Realized losses:		
Fixed maturities		
Equity securities:		

Sales	**(0.8)**	(5.9)
OTTI	**(0.8)**	(6.4)
Total realized losses	**(1.6)**	(12.3)
Net realized gain (loss) on investments	**$ 3.2**	(11.3)
Change in unrealized holding gains (losses):		
Fixed maturities	**$ 1.7**	32.5
Equity securities	**5.5**	(4.8)
Other invested assets	**1.1**	(4.5)
Deferred federal income tax liability thereon	**(2.9)**	(8.2)
Valuation allowance		2.6
Change in net unrealized holding gains (losses)	**$ 5.4**	17.6

There was a deferred federal income tax liability on the net unrealized holding gains at March 31, 2010 and December 31, 2009, of $33.1 million and $30.2 million, respectively.

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 March 31, 2010 and December 31, 2009, the Company did not adjust any of the prices received from the pricing service.

Transfers between level categorizations may occur due to changes in the availability of market observable inputs. Transfers in and out of level categorizations are reported as having occurred at the beginning of the quarter in which the transfer occurred. There were no transfers between level categorizations during the three months ended March 31, 2010 and 2009.

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

Fixed Maturities

The Company utilizes a pricing service to estimate fair value measurements for approximately 99.9% of its fixed maturities. The fair value estimate of the Company s fixed maturity investments are determined by evaluations that are based on observable market information rather than market quotes. Inputs to the evaluations include, but are not limited to, market prices from recently completed transactions and transactions of comparable securities, interest rate yield curves, credit spreads, and other market-observable information. Investments valued using these inputs include U.S. treasury securities and obligations of U.S. government agencies, obligations of states and political subdivisions, corporate securities (except for one security discussed below), and U.S. government agencies residential mortgage-backed securities. All unadjusted estimates of fair value for fixed maturities priced by the pricing service are included in the amounts disclosed in Level 2 of the hierarchy. At March 31, 2010 and December 31, 2009, the pricing service provided all valuations for the fixed maturity securities, except for one fixed maturity security discussed below.

The Company holds one fixed maturity corporate security for which the Company estimates the fair value of this security using the present value of the future cash flows. Due to the limited amount of observable market information, the Company includes the fair value estimates for this security in Level 3.

Equities

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

Other Invested Assets

Included in other invested assets are two international private equity funds (the funds) that invest in equity securities of foreign issuers and are managed by third party investment managers. The funds had a fair value of $57.3 million and $48.3 million at March 31, 2010 and December 31, 2009, 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

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)

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, which were historically classified as a Level 3, were transferred out of Level 3 and into Level 2 as of October 1, 2009.

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.

The following table reflects the Company s available-for-sale investments within the fair value hierarchy at March 31, 2010 and December 31, 2009:

($ millions)		**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**
At March 31, 2010:	**Total**			
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	**$ 394.0**		**394.0**	
Obligations of states and political subdivisions	**1,017.7**		**1,017.7**	
Corporate securities	**110.9**		**108.5**	**2.4**
U.S. government agencies residential mortgage-backed securities	**294.4**		**294.4**	
Total fixed maturities	**1,817.0**		**1,814.6**	**2.4**
Equity securities:				
Large-cap equity securities	**224.6**	**224.6**		
Small-cap equity securities	**36.0**	**36.0**		
Total equity securities	**260.6**	**260.6**		
Other invested assets	**61.4**	**4.1**	**57.3**	
Total available-for-sale investments	**$ 2,139.0**	**264.7**	**1,871.9**	**2.4**

($ millions)		Quoted prices	Significant	Significant

At December 31, 2009:	Total	in active markets for identical assets (Level 1)	other observable inputs (Level 2)	unobservable inputs (Level 3)
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	$ 352.9		352.9	
Obligations of states and political subdivisions	1,078.6		1,078.6	
Corporate securities	99.7		97.4	2.3
U.S. government agencies residential mortgage-backed securities	300.6		300.6	
Total fixed maturities	1,831.8		1,829.5	2.3
Equity securities:				
Large-cap equity securities	196.1	196.1		
Small-cap equity securities	28.0	28.0		
Total equity securities	224.1	224.1		
Other invested assets	52.3	4.0	48.3	
Total available-for-sale investments	$ 2,108.2	228.1	1,877.8	2.3

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)

For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances for the three months ended March 31, 2010 and 2009, separately for each major category of assets is as follows:

($ millions)	**Fixed maturities**
Balance at January 1, 2010	**$ 2.3**
Total realized gains and losses	
Included in other comprehensive income - total gains or losses unrealized	**0.1**
Purchases, issuances, and settlements	
Transfers in and/or out of Level 3	
Balance at March 31, 2010	**$ 2.4**

($ millions)	Fixed maturities	Other invested assets
Balance at January 1, 2009	$ 2.3	28.8
Total realized gains and losses		(4.6)
Included in other comprehensive loss - total gains or losses unrealized	0.2	0.2
Purchases, issuances, and settlements		
Transfers in and/or out of Level 3		
Balance at March 31, 2009	$ 2.5	24.4

Below is a summary of the carrying value and fair value of financial instruments at March 31, 2010:

($ millions)	Carrying value	Fair value	Reference
Assets:			
Fixed maturities, available-for-sale, at fair value	$ 1,817.0	$ 1,817.0	See above
Equity securities, available-for-sale, at fair value	260.6	260.6	See above
Other invested assets, available-for-sale, at fair value	61.4	61.4	See above
Notes receivable from affiliate	70.0	68.9	See Note 5
Liabilities:			
Notes payable	117.1	120.4	See Note 6

4. Reinsurance

A quota share reinsurance pooling arrangement (the Pooling Arrangement) exists between State Auto Property & Casualty Insurance Company (State Auto P&C), Milbank Insurance Company (Milbank), Farmers Casualty Insurance Company (Farmers), State Auto Insurance Company of Ohio (SA Ohio), and effective January 1, 2010 State Auto National Insurance Company (SA National) (collectively referred to as the STFC Pooled Companies) and State Automobile Mutual Insurance Company (State Auto Mutual) and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin (SA Wisconsin), State Auto Florida Insurance Company (SA Florida), Meridian Citizens Mutual Insurance Company (Meridian Citizens Mutual), Meridian Security Insurance Company (Meridian Security), Beacon National Insurance Company (Beacon National), Patrons Mutual Insurance Company of Connecticut (Patrons Mutual), and Litchfield Mutual Fire Insurance Company (Litchfield) (collectively referred to as the Mutual Pooled Companies). Together, the STFC Pooled Companies and Mutual Pooled Companies are collectively referred to as the Pooled Companies or the State Auto Pool. The Pooled Companies and Beacon Lloyds Insurance Company are collectively referred to herein as the State Auto Group.

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)

Effective January 1, 2010, the Pooling Arrangement was further amended to add SA National to the pool with a participation percentage of 0.0% and to include voluntary assumed reinsurance from third parties unaffiliated with the Pooled Companies that was assumed on or after January 1, 2009. In conjunction with the January 1, 2010 Pooling Arrangement amendment, the STFC Pooled Companies received $3.7 million in cash from the Mutual Pooled Companies for net insurance assets transferred on January 1, 2010. The following table presents the impact on the Company s balance sheet at January 1, 2010, relating to the Pooling Arrangement amendment:

($ millions)	
Losses and loss expenses payable	$ (4.0)
Unearned premiums	(1.4)
Other liabilities	(0.6)
Less:	
Deferred policy acquisition costs	(0.2)
Other assets	(9.5)
Net cash received	$ 3.7

The following table provides a summary of the Company s reinsurance transactions with other insurers and reinsurers, as well as reinsurance transactions with affiliates:

($ millions)	Three months ended March 31	
	2010	2009
Premiums earned:		
Assumed from other insurers and reinsurers	**$ 1.1**	1.1
Assumed under State Auto Pool and other affiliate arrangements	**302.6**	276.0
Ceded to other insurers and reinsurers	**(6.5)**	(6.6)
Ceded under State Auto Pool and other affiliate arrangements	**(201.7)**	(179.9)
Net assumed premiums earned	**$ 95.5**	90.6
Losses and loss expenses incurred:		
Assumed from other insurers and reinsurers	**$ 0.3**	0.2
Assumed under State Auto Pool and other affiliate arrangements	**198.3**	215.3
Ceded to other insurers and reinsurers	**0.3**	(1.8)
Ceded under State Auto Pool and other affiliate arrangements	**(134.1)**	(139.7)

Net assumed losses and loss expenses incurred	**$ 64.8**	74.0

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)

5. Transactions with Affiliates

In May 2009, the Company entered into two separate Credit Agreements with State Auto Mutual, in which it loaned State Auto Mutual $70.0 million for ten years. Under this agreement, State Auto Financial earned interest of $1.2 million for the three months ended March 31, 2010. Interest income is included in net investment income on the condensed consolidated statements of income.

The Company estimates the fair value of the notes receivable from affiliate using market quotations for U.S. treasury securities with similar maturity dates and applies an appropriate credit spread. Notes receivable at March 31, 2010 and December 31, 2009, consisted of the following:

($ millions, except interest rates)	**March 31, 2010**			December 31, 2009		
	Carrying value	**Fair value**	**Interest rate**	Carrying value	Fair value	Interest rate
Notes receivable from affiliate	**$ 70.0**	**$ 68.9**	**7.00%**	$ 70.0	$ 69.9	7.00%

6. Notes Payable

The carrying amount of the Subordinated Debentures included in notes payable on the consolidated balance sheets approximates its fair value as the interest rate adjusts quarterly. The fair value of the Senior Notes is based on the quoted market price. Notes payable at March 31, 2010 and December 31, 2009, consisted of the following:

($ millions, except interest rates)	**March 31, 2010**			December 31, 2009		
	Carrying value	**Fair value**	**Interest rate**	Carrying value	Fair value	Interest rate
Senior Notes due 2013: issued $100.0, November 2003 with fixed interest	**$ 101.6**	**$ 104.9**	**6.25%**	$ 101.7	$ 101.8	6.25%
Affiliate Subordinated Debentures due 2033: issued $15.5, May 2003 with variable interest	**15.5**	**15.5**	**4.45**	15.5	15.5	4.46
Total notes payable	**$ 117.1**	**$ 120.4**		$ 117.2	$ 117.3	

7. Income Taxes

Federal income tax expense for the three months ended March 31, 2010, was computed using an expected annual effective tax rate of 15.3%. The effective tax rate differs from the statutory rate of 35% principally because of tax exempt investment income. In addition, during the first quarter 2010, the Company incurred a one-time tax charge of $4.5 million related to the recently enacted federal health care legislation. This legislation eliminated the tax benefit associated with Medicare Part D subsidies the Company receives for providing qualifying prescription drug coverage to retirees. Collectively, this amounted to an effective tax rate of 37.3% for the three months ended March 31, 2010.

For the three months ended March 31, 2009, the uncertainty of the Company s expected full year results at the time precluded the Company from making a reliable estimate of the effective tax rate. Accordingly, the Company recorded a tax benefit based on the actual results for the three months ended March 31, 2009.

8. Restructuring Costs

In June 2009, the Company initiated a plan to restructure its field and claims operations. Restructuring charges, including employee termination benefits, relocation packages, and costs associated with ceasing to use leased properties, related to this reorganization have been recognized in accordance with the Exit or Disposal Cost Obligations Topic of the FASB ASC. Consideration of this restructuring resulted in a curtailment of the Company s pension and postretirement benefit plans, due to the elimination of expected years of future services of those impacted employees. The Company recognized restructuring costs totaling $1.4 million during the three months ended March 31, 2010, and anticipates additional charges of approximately $1.4 million through the fourth quarter 2010, the expected completion date of the restructuring. These charges are included in losses and loss expenses and acquisition and operating expenses on the condensed consolidated statements of income.

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)

Total cumulative estimated costs to be incurred, costs incurred during the three months ended March 31, 2010, and total cumulative costs incurred through March 31, 2010 are as follows:

($ millions)	Total cumulative estimated costs to be incurred	Costs incurred during the three months ended March 31, 2010	Cumulative costs incurred through March 31, 2010
Employee termination benefits	$ 6.8	1.4	5.9
Relocation costs	3.3	0.4	1.8
Lease termination	0.4	0.1	0.3
Benefit plan curtailment gain	(2.9)	(0.5)	(1.8)
Total	$ 7.6	1.4	6.2

These costs are allocated to the Company s insurance segments as follows:

($ millions)	Total cumulative estimated costs to be incurred	Costs incurred during the three months ended March 31, 2010	Cumulative costs incurred through March 31, 2010
Personal insurance	$ 3.8	0.8	3.3
Business insurance	3.8	0.6	2.9
Total	$ 7.6	1.4	6.2

Activity for the three months ended March 31, 2010, was as follows:

($ millions)	Balance of liability at January 1, 2010	Costs incurred during the three months ended March 31, 2010	Amounts paid during the three months ended March 31, 2010	Balance of liability at March 31, 2010
Employee termination benefits	$ 3.9	1.4	0.8	4.5
Relocation costs		0.4	0.4	

Lease termination	0.1	0.1	0.1	0.1
Benefit plan curtailment gain (non-cash item)		(0.5)		
Total	$ 4.0	1.4	1.3	4.6

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)

9. Pension and Postretirement Benefit Plans

The following table provides components of net periodic cost for the State Auto Group s pension and postretirement benefit plans:

($ millions)	Pension		Postretirement	
	Three months ended March 31			
	2010	2009	**2010**	2009
Service cost	**$ 2.6**	2.3	**$ 1.1**	1.4
Interest cost	**3.7**	3.1	**1.4**	1.8
Expected return on plan assets	**(4.4)**	(4.5)	**(0.1)**	
Curtailment loss (gain)			**(0.5)**	
Amortization of:				
Prior service costs (benefits)	**0.1**	0.1	**(0.4)**	0.1
Transition assets	**(0.2)**	(0.2)		
Net loss	**1.4**	1.0		0.2
Net periodic cost	**$ 3.2**	1.8	**$ 1.5**	3.5

The Company expects to contribute up to $15.0 million to its pension plan during 2010.

10. Earnings (Loss) per Common Share

The following table sets forth the computation of basic and diluted earnings (loss) per common share:

($ millions, except per share amounts)	Three months ended March 31	
	2010	2009
Numerator:		
Net income (loss) for basic earnings (loss) per share	**$ 12.9**	(14.0)
Denominator:		
Basic weighted average shares outstanding	**39.8**	39.6
Effect of dilutive share-based awards	**0.2**	
Diluted weighted average shares outstanding	**40.0**	39.6
Basic earnings (loss) per share	**$ 0.32**	(0.35)

Diluted earnings (loss) per share	**$ 0.32**	(0.35)

The following number of options to purchase shares of common stock was not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price or their inclusion would have been antidilutive:

(number of options in millions)	Three months ended March 31	
	2010	2009
Number of options	**2.2**	1.8

15

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

11. Comprehensive Income

The components of comprehensive income, net of related tax, are as follows:

($ millions)	Three months ended March 31	
	2010	2009
Net income (loss)	**$ 12.9**	(14.0)
Other comprehensive income:		
Change in unrealized holding gains, net of tax	**5.4**	17.6
Change in unrecognized benefit plan obligations, net of tax	**0.3**	0.6
Total other comprehensive income	**5.7**	18.2
Comprehensive income	**$ 18.6**	4.2

12. Segment Information

The Company has three reportable segments: personal insurance, business 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 operate primarily in the Midwestern, Southern, Southwestern, and Eastern states distributing products primarily through the independent insurance agency system. The personal insurance segment provides primarily personal auto (standard and nonstandard) and homeowners to the personal insurance market. The business insurance segment provides primarily commercial auto, commercial multi-peril, fire & allied lines, other & product liability and workers compensation insurance to small-to-medium sized businesses within the commercial insurance market. The investment operations segment, managed by Stateco Financial Services, Inc. (Stateco), a wholly-owned subsidiary, provides investment services.

The Company evaluates the performance of its insurance segments using industry financial measurements based on Statutory Accounting Principles (SAP), which include loss and loss adjustment expense ratios, underwriting expense ratios, combined ratios, statutory underwriting gain (loss), net premiums earned and net premiums written. 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 provides financial information regarding the Company s reportable segments:

($ millions)	Three months ended March 31 2010	2009
Revenues from external sources:		
Insurance segments		
Personal insurance	**$ 193.9**	173.8
Business insurance	**108.7**	112.2
Total insurance segments	**302.6**	286.0
Investment operations segment		
Net investment income	**20.5**	18.3
Net realized capital gains (losses)	**3.2**	(11.3)
Total investment operations segment	**23.7**	7.0
All other	**0.4**	1.0
Total revenues from external sources	**326.7**	296.5
Intersegment revenues:	**(2.4)**	(2.5)
Total revenues	**324.3**	294.0
Reconciling items:		
GAAP premium adjustments	**(0.3)**	
Eliminate intersegment revenues	**2.4**	2.5
Total consolidated revenues	**$ 326.4**	294.0
Segment income (loss) before federal income tax:		
Insurance segments		
Personal insurance SAP underwriting gain (loss)	**$ 5.7**	(27.1)
Business insurance SAP underwriting loss	**(2.0)**	(3.5)
Total insurance segments	**3.7**	(30.6)
Investment operations segment		
Net investment income	**20.5**	18.3
Net realized capital gains (losses)	**3.2**	(11.3)
Total investment operations segment	**23.7**	7.0
All other segments		(0.5)

Total segment income (loss) before tax expense (benefit)	**27.4**	(24.1)
Reconciling items:		
GAAP expense adjustments	**(4.8)**	(4.8)
Interest expense on corporate debt	**(1.8)**	(2.0)
Corporate expenses	**(0.2)**	
Total reconciling items	**(6.8)**	(6.8)
Total consolidated income (loss) before federal income tax expense (benefit)	**$ 20.6**	(30.9)

17

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)

Revenues from external sources for reportable segments include the following products and services:

($ millions)	Three months ended March 31	
	2010	2009
Earned premiums:		
Personal insurance:		
Standard personal auto	**$ 116.6**	101.5
Nonstandard personal auto	**7.3**	10.0
Homeowners	**61.9**	54.8
Other personal	**8.1**	7.5
Total personal insurance earned premiums	**193.9**	173.8
Business insurance:		
Commercial auto	**25.0**	27.2
Commercial multi-peril	**24.3**	24.0
Fire & allied lines	**24.8**	23.8
Other & product liability	**17.8**	19.4
Workers compensation	**10.4**	10.9
Other business	**6.4**	6.9
Total business insurance earned premiums	**108.7**	112.2
Total SAP earned premiums	**302.6**	286.0
GAAP premium adjustment	**(0.3)**	
Total GAAP earned premiums	**302.3**	286.0
Investment operations:		
Net investment income	**20.5**	18.3
Net realized capital gain (loss)	**3.2**	(11.3)
Total investment operations	**23.7**	7.0
Total revenues from reportable segments	**$ 326.0**	293.0

Investable assets attributable to our investment operations segment totaled $2,290.1 million at March 31, 2010 and $2,269.4 million at December 31, 2009.

13. Contingencies and Litigation

The Company s insurance subsidiaries are involved in a number of lawsuits, and may become involved in other potential litigation, arising in the ordinary course of business. Generally, the involvement of an insurance subsidiary in a lawsuit involves defending third-party claims brought against its insureds (in its role as liability insurer) or as a principal of surety bonds and defending policy coverage claims brought against the insurance subsidiary. All lawsuits relating to such insurance claims are considered by the Company in establishing the Company s loss and loss adjustment expense reserves.

In accordance with the Contingencies Topic of the FASB ASC, the Company accrues for a litigation-related liability other than insurance claims when it is probable that such a liability has been incurred and the amount of the loss can be reasonably estimated. Based on currently available information known to the Company, the Company believes that its reserves for these litigation-related liabilities are reasonable and that the ultimate outcomes of any pending matters are not likely to have a material adverse effect on its consolidated financial position or results of operations.

Additionally, the insurance subsidiaries may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope originally contemplated in their 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 position or results from operations.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

The term State Auto Financial as used below refers only to State Auto Financial Corporation and the terms our Company, we, us, and our used below refer to State Auto Financial Corporation and its consolidated subsidiaries. The term first quarter as used below refers to the three months ended March 31 for the time period then ended. The term SAP as used below refers to Statutory Accounting Principles and the term GAAP as used below refers to U.S. Generally Accepted Accounting Principles.

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 March 31, 2010 and December 31, 2009, and for the consolidated statements of income for the three-month periods ended March 31, 2010 and 2009. This discussion and analysis should be read together with Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for our year ended December 31, 2009 (the 2009 Form 10-K), and in particular the discussions in those sections thereof entitled Executive Summary and Critical Accounting Policies. Readers are encouraged to review the entire 2009 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 neg variations thereon or similar terminology. Forward-looking statements speak only as of the date the statements were made. Although we believe that the expectations reflected in forward-looking statements have a reasonable basis, we can give no assurance that these expectations will prove to be correct. Forward-looking statements are subject to risks and uncertainties that could cause actual events or results to differ materially from those expressed in or implied by the statements. For a discussion of the most significant risks and uncertainties that could cause our actual results to differ materially from those projected, see Risk Factors in Item 1A of the 2009 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.

Our reportable segments are personal insurance, business insurance (collectively the insurance segments or our insurance segments) and investment operations. These segments reflect the manner in which we manage our business and report our results internally to our principal operating decision makers. The personal insurance segment provides primarily personal auto (standard and nonstandard) and homeowners to the personal insurance market. The business insurance segment provides primarily commercial auto, commercial multi-peril, fire & allied lines, other & product liability and workers compensation insurance to small to medium sized businesses within the commercial insurance market. The investment operations segment, managed by our subsidiary Stateco Financial Services, Inc., provides investment services for our invested assets. Our investment portfolio is comprised primarily of publicly traded fixed income and equity securities. Financial information about our reportable segments is set forth in Note 12 of our Condensed Consolidated Financial Statements included in Item 1 of this Form 10-Q.

A quota share reinsurance pooling arrangement (the Pooling Arrangement) exists between State Auto Property & Casualty Insurance Company (State Auto P&C), Milbank Insurance Company (Milbank), Farmers Casualty Insurance Company (Farmers), State Auto Insurance Company of Ohio (SA Ohio), and, as of January 1, 2010, State Auto National Insurance Company (SA National) (collectively referred to as the STFC Pooled Companies), and State Automobile Mutual Insurance Company (State Auto Mutual) and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin (SA Wisconsin), State Auto Florida Insurance Company (SA Florida), Meridian Citizens Mutual Insurance Company (Meridian Citizens Mutual), Meridian Security Insurance Company (Meridian Security), Patrons Mutual Insurance Company of Connecticut (Patrons Mutual), and Litchfield Mutual Fire Insurance Company (Litchfield), and Beacon National Insurance Company (Beacon National) (collectively referred to as the Mutual Pooled Companies). Together, the STFC Pooled Companies and Mutual Pooled Companies are collectively referred to as the Pooled Companies or the State Auto Pool. The State Auto Pool has an A.M. Best rating of A+ (Superior). The Pooled Companies and Beacon Lloyds Insurance Company are collectively referred to herein as the State Auto Group. See the 2009 Form 10-K and the section Important Defined Terms Used in this Form 10-K.

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

($ millions)

Losses and loss expenses payable	$ (4.0)
Unearned premiums	(1.4)
Other liabilities	(0.6)
Less:	
Deferred policy acquisition costs	(0.2)
Other assets	(9.5)
Net cash received	$ 3.7

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

	January 1, 2009 December 31, 2009	**January 1, 2010 March 31, 2010**
STFC Pooled Companies:		
State Auto P&C	59.0%	**59.0%**
Milbank	17.0	**17.0**
Farmers	3.0	**3.0**
SA Ohio	1.0	**1.0**
SA National	N/A	**0.0**
Total	80.0	**80.0**
State Auto Mutual Pooled Companies:		
State Auto Mutual	19.0	**19.0**
SA Wisconsin	0.0	**0.0**
SA Florida	0.0	**0.0**
Meridian Security	0.0	**0.0**
Meridian Citizens Mutual	0.5	**0.5**
Beacon National	0.0	**0.0**
Patrons Mutual	0.4	**0.4**
Litchfield	0.1	**0.1**

Total	20.0	**20.0**

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

RESULTS OF OPERATIONS

We recognized net income of $12.9 million and net loss of $14.0 million for the three months ended March 31, 2010 and 2009, respectively. The first quarter 2010 pretax income was $20.6 million while the first quarter 2009 pretax loss was $30.9 million. First quarter 2010 results were favorably impacted for our insurance segments by an increase in earned premium due to growth in our personal lines and a decrease in the level of catastrophe losses, and for our investment segment by an increase in levels of realized investment gains and investment income. The following table summarizes certain key performance metrics for first quarters 2010 and 2009 that we use to monitor our financial performance:

($ millions, except per share amounts)	Three months ended March 31	
GAAP Basis:	**2010**	2009
Total revenues	**$ 326.4**	294.0
Net income (loss)	**$ 12.9**	(14.0)
Stockholders equity	**$ 863.5**	760.7
Return on average equity[2]	**4.6%**	(4.0)
Book value per share	**$ 21.65**	19.21
Debt to capital ratio	**11.9**	13.4
Loss and LAE ratio [1]	**66.2%**	78.6
Expense ratio [1]	**33.5%**	33.4
Combined ratio [1]	**99.7%**	112.0
Catastrophe loss and LAE points		