

State Auto Financial CORP
Form 10-Q
August 06, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2013

or

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

Commission File Number 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

Ohio (State or other jurisdiction of incorporation or organization)	31-1324304 (I.R.S. Employer Identification No.)
518 East Broad Street, Columbus, Ohio (Address of principal executive offices)	43215-3976 (Zip Code)
Registrant's telephone number, including area code: (614) 464-5000	

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

Yes No

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

Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes No

On July 26, 2013, the Registrant had 40,631,281 Common Shares outstanding.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

(\$ in millions, except per share amount)

	June 30, 2013 (unaudited)	December 31, 2012
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,770.5 and \$1,776.2, respectively)	\$ 1,820.9	1,905.1
Equity securities, available-for-sale, at fair value (cost \$198.7 and \$196.2, respectively)	248.9	228.4
Other invested assets, available-for-sale, at fair value (cost \$49.2 and \$49.0, respectively)	69.2	64.4
Other invested assets	0.5	0.5
Notes receivable from affiliate	70.0	70.0
Total investments	2,209.5	2,268.4
Cash and cash equivalents	68.5	59.0
Accrued investment income and other assets	34.3	31.5
Deferred policy acquisition costs	100.4	91.7
Reinsurance recoverable on losses and loss expenses payable	13.2	13.5
Prepaid reinsurance premiums	4.4	3.9
Due from affiliate	23.2	
Current federal income taxes	0.2	
Net deferred federal income taxes	8.6	1.0
Property and equipment, at cost	8.4	8.8
Total assets	\$ 2,470.7	2,477.8
Liabilities and Stockholders Equity		
Losses and loss expenses payable (affiliates \$424.6 and \$435.1, respectively)	\$ 955.7	942.2
Unearned premiums (affiliates \$94.5 and \$81.9, respectively)	507.3	481.6
Notes payable (affiliates \$15.5 and \$15.5, respectively)	115.7	115.9
Postretirement and pension benefits	107.8	113.0
Due to affiliate		8.6
Other liabilities	72.9	79.3
Total liabilities	1,759.4	1,740.6
Stockholders equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued		
Common stock, without par value. Authorized 100.0 shares; 47.4 and 47.3 shares issued, respectively, at stated value of \$2.50 per share	118.5	118.1
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	(115.9)	(115.8)

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Additional paid-in capital	134.2	131.6
Accumulated other comprehensive income	37.6	84.2
Retained earnings	536.9	519.1
<i>Total stockholders equity</i>	711.3	737.2
<i>Total liabilities and stockholders equity</i>	\$ 2,470.7	2,477.8

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

<i>(\$ in millions, except per share amounts)</i>	Three months ended June 30	
(unaudited)	2013	2012
Earned premiums (ceded to affiliates \$213.1 and \$199.8, respectively)	\$ 263.5	258.4
Net investment income (affiliate \$1.2 and \$1.2, respectively)	19.7	20.5
Net realized gain on investments:		
Total other-than-temporary impairment losses	(2.0)	(1.3)
Portion of loss recognized in other comprehensive income		
Other net realized investment gains	3.5	8.0
Total net realized gain on investments	1.5	6.7
Other income from affiliates	0.6	1.1
Total revenues	285.3	286.7
Losses and loss expenses (ceded to affiliates \$164.4 and \$167.7, respectively)	186.1	201.7
Acquisition and operating expenses	87.0	83.6
Interest expense (affiliates \$0.2 and \$0.2, respectively)	3.8	1.7
Other expenses	2.1	2.4
Total expenses	279.0	289.4
Income (loss) before federal income taxes	6.3	(2.7)
Federal income tax expense	0.1	
Net income (loss)	\$ 6.2	(2.7)
Earnings (loss) per common share:		
Basic	\$ 0.15	(0.07)
Diluted	\$ 0.15	(0.07)
Dividends paid per common share	\$ 0.10	0.15

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

<i>(\$ in millions, except per share amounts)</i>	Six months ended June 30	
(unaudited)	2013	2012
Earned premiums (ceded to affiliates \$423.8 and \$396.7, respectively)	\$ 524.8	513.3
Net investment income (affiliate \$2.4 and \$2.4, respectively)	36.6	38.0
Net realized gain on investments:		
Total other-than-temporary impairment losses	(2.3)	(1.7)
Portion of loss recognized in other comprehensive income		
Other net realized investment gains	10.5	15.5
Total net realized gain on investments	8.2	13.8
Other income from affiliates	1.0	1.9
Total revenues	570.6	567.0
Losses and loss expenses (ceded to affiliates \$296.2 and \$323.8, respectively)	359.1	393.0
Acquisition and operating expenses	175.8	171.2
Interest expense (affiliates \$0.4 and \$0.4, respectively)	5.5	3.5
Other expenses	3.9	4.0
Total expenses	544.3	571.7
Income (loss) before federal income taxes	26.3	(4.7)
Federal income tax expense	0.4	
Net income (loss)	\$ 25.9	(4.7)
Earnings (loss) per common share:		
Basic	\$ 0.64	(0.12)
Diluted	\$ 0.64	(0.12)
Dividends paid per common share	\$ 0.20	0.30

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income

(\$ in millions, except per share amounts)

	Three months ended June 30	
(unaudited)	2013	2012
Net income (loss)	\$ 6.2	(2.7)
Other comprehensive (loss) income, net of tax:		
Net unrealized holding (loss) gain on investments:		
Unrealized holding (loss) gain arising during the period ended	(67.1)	0.5
Reclassification adjustments for gain realized in net income (loss)	(1.5)	(6.7)
Income tax benefit	7.3	0.3
<i>Total net unrealized holding loss on investments</i>	(61.3)	(5.9)
Amortization of gain on derivative used in cash flow hedge	(0.1)	(0.1)
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Transition asset	0.1	
Negative prior service cost	(1.4)	(1.3)
Net actuarial loss	2.2	1.9
<i>Total net unrecognized benefit plan obligations</i>	0.9	0.6
<i>Other comprehensive loss, net of tax</i>	(60.5)	(5.4)
Comprehensive loss, net of tax	\$ (54.3)	(8.1)

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income

<i>(\$ in millions, except per share amounts)</i>	Six months ended June 30	
(unaudited)	2013	2012
Net income (loss)	\$ 25.9	(4.7)
Other comprehensive (loss) income, net of tax:		
Net unrealized holding gain (loss) on investments:		
Unrealized holding (loss) gain arising during the period ended	(47.7)	22.6
Reclassification adjustments for gain realized in net income (loss)	(8.2)	(13.8)
Income tax benefit	7.6	0.3
<i>Total net unrealized holding (loss) gain on investments</i>	(48.3)	9.1
Amortization of gain on derivative used in cash flow hedge	(0.1)	(0.1)
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Transition asset	0.2	0.1
Negative prior service cost	(2.8)	(2.6)
Net actuarial loss	4.4	3.8
<i>Total net unrecognized benefit plan obligations</i>	1.8	1.3
<i>Other comprehensive (loss) income, net of tax</i>	(46.6)	10.3
Comprehensive (loss) income, net of tax	\$ (20.7)	5.6

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Cash Flows

<i>(\$ in millions)</i>	Six months ended June 30	
(unaudited)	2013	2012
Cash flows from operating activities:		
Net income (loss)	\$ 25.9	(4.7)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization, net	6.4	2.2
Share-based compensation	2.5	1.9
Net realized gain on investments	(8.2)	(13.8)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(8.7)	(1.9)
Accrued investment income and other assets	(2.0)	2.5
Postretirement and pension benefits	(3.3)	(2.3)
Other liabilities and due to/from affiliates, net	(39.8)	(23.3)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	(0.2)	3.2
Losses and loss expenses payable	13.5	26.6
Unearned premiums	25.7	21.2
Federal income taxes	(0.2)	1.1
Cash used in Homeowners Quota Share initial net unearned premium transfer		(75.5)
Cash used in pooling changes, December 31, 2011		(261.4)
Net cash provided by (used in) operating activities	11.6	(324.2)
Cash flows from investing activities:		
Purchases of fixed maturities available-for-sale	(144.2)	(259.2)
Purchases of equity securities available-for-sale	(39.5)	(64.7)
Purchases of other invested assets	(0.5)	(0.7)
Maturities, calls and pay downs of fixed maturities available-for-sale	86.7	147.4
Sales of fixed maturities available-for-sale	58.2	170.8
Sales of equity securities available-for-sale	43.2	41.1
Sales of other invested assets	0.4	0.4
Net additions (reductions) of property and equipment	0.2	(0.2)
Net cash provided by investing activities	4.5	34.9
Cash flows from financing activities:		
Proceeds from issuance of common stock	1.6	0.8
Payments to acquire treasury stock	(0.1)	
Payment of dividends	(8.1)	(12.1)
Net cash used in financing activities	(6.6)	(11.3)

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Net increase (decrease) in cash and cash equivalents	9.5	(300.6)
Cash and cash equivalents at beginning of period	59.0	356.0
Cash and cash equivalents at end of period	\$ 68.5	55.4
<u>Supplemental disclosures:</u>		
Interest paid (affiliates \$0.3 and \$0.4, respectively)	\$ 3.5	3.5
Federal income taxes paid (received)	\$ 0.6	(1.1)

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements (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 periods ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. The balance sheet at December 31, 2012 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, 2012 (the 2012 Form 10-K). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2012 Form 10-K.

Adoption of Accounting Pronouncements

Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income

The amendments in this guidance result in additional disclosure requirements under GAAP and do not change the current requirements for reporting net income or other comprehensive income in financial statements. The new guidance requires an entity to present, either in a single note, or, parenthetically on the face of the statement where net income is presented, the effects of significant amounts reclassified from each component of accumulated other comprehensive income by the respective line items of net income, only, if the amount reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period. If a component is not required to be reclassified to net income in its entirety, the entity would, instead, cross-reference it to the related disclosure required under GAAP. This guidance is effective prospectively for fiscal years and interim periods beginning after December 15, 2012. The Company adopted this guidance at January 1, 2013 and it did not have a material impact on the consolidated financial statements, see Note 7 - Other Comprehensive Income and Accumulated Other Comprehensive Income.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

2. Investments

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at June 30, 2013 and December 31, 2012:

(\$ millions)

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
At June 30, 2013:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 312.2	18.5	(2.2)	328.5
Obligations of states and political subdivisions	801.6	32.5	(14.5)	819.6
Corporate securities	319.4	11.0	(5.0)	325.4
U.S. government agencies residential mortgage-backed securities	337.3	12.8	(2.7)	347.4
<i>Total fixed maturities</i>	1,770.5	74.8	(24.4)	1,820.9
Equity securities:				
Large-cap securities	153.7	37.8	(3.6)	187.9
Small-cap securities	45.0	16.0		61.0
<i>Total equity securities</i>	198.7	53.8	(3.6)	248.9
Other invested assets	49.2	20.0		69.2
<i>Total available-for-sale securities</i>	\$ 2,018.4	148.6	(28.0)	2,139.0

(\$ millions)

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
At December 31, 2012:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 328.2	38.3		366.5
Obligations of states and political subdivisions	750.4	50.3	(0.4)	800.3
Corporate securities	320.5	19.2	(1.1)	338.6
U.S. government agencies residential mortgage-backed securities	377.1	24.0	(1.4)	399.7
<i>Total fixed maturities</i>	1,776.2	131.8	(2.9)	1,905.1
Equity securities:				
Large-cap securities	152.6	25.0	(3.4)	174.2

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Small-cap securities	43.6	10.6		54.2
<i>Total equity securities</i>	196.2	35.6	(3.4)	228.4
Other invested assets	49.0	15.4		64.4
<i>Total available-for-sale securities</i>	\$ 2,021.4	182.8	(6.3)	2,197.9

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The 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, 2013 and December 31, 2012:

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
At June 30, 2013:									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$ 55.3	\$ (2.2)	17	\$	\$		\$ 55.3	\$ (2.2)	17
Obligations of states and political subdivisions	233.4	(14.5)	80				233.4	(14.5)	80
Corporate securities	132.7	(5.0)	24				132.7	(5.0)	24
U.S. government agencies residential mortgage-backed securities	51.6	(1.6)	15	31.2	(1.1)	12	82.8	(2.7)	27
Total fixed maturities	473.0	(23.3)	136	31.2	(1.1)	12	504.2	(24.4)	148
Large-cap equity securities	15.0	(2.5)	3	6.5	(1.1)	3	21.5	(3.6)	6
Total temporarily impaired securities	\$ 488.0	\$ (25.8)	139	\$ 37.7	\$ (2.2)	15	\$ 525.7	\$ (28.0)	154

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
At December 31, 2012:									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$ 7.0	\$	2	\$	\$		\$ 7.0	\$	2
Obligations of states and political subdivisions	47.4	(0.4)	12				47.4	(0.4)	12
Corporate securities	80.4	(1.1)	17				80.4	(1.1)	17
U.S. government agencies residential mortgage-backed securities	23.3	(0.3)	6	34.8	(1.1)	13	58.1	(1.4)	19

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<i>Total fixed maturities</i>	158.1	(1.8)	37	34.8	(1.1)	13	192.9	(2.9)	50
Large-cap equity securities	23.7	(2.1)	4	8.9	(1.3)	5	32.6	(3.4)	9
<i>Total temporarily impaired securities</i>	\$ 181.8	\$ (3.9)	41	\$ 43.7	\$ (2.4)	18	\$ 225.5	\$ (6.3)	59

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The Company reviewed its investments at June 30, 2013, and determined 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, 2013 and 2012:

(\$ millions)	Three months ended		Six months ended	
	June 30 2013	2012	June 30 2013	2012
Equity securities:				
Large-cap securities	\$ (1.3)		\$ (1.3)	
Small-cap securities	(0.7)	(1.1)	(1.0)	(1.5)
Fixed maturities:		(0.2)		(0.2)
<i>Total other-than-temporary impairments</i>	\$ (2.0)	(1.3)	\$ (2.3)	(1.7)

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, 2013:

(\$ millions)	Amortized cost	Fair value
Due in 1 year or less	\$ 55.6	\$ 56.4
Due after 1 year through 5 years	331.4	348.0

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Due after 5 years through 10 years	386.7	405.1
Due after 10 years	659.5	664.0
U.S. government agencies residential mortgage-backed securities	337.3	347.4
<i>Total</i>	\$ 1,770.5	\$ 1,820.9

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 \$8.6 and \$10.0 million, respectively, were on deposit with insurance regulators as required by law at June 30, 2013 and December 31, 2012.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the components of net investment income for the three and six months ended June 30, 2013 and 2012:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Fixed maturities	\$ 17.2	18.7	\$ 32.0	34.4
Equity securities	1.6	1.0	2.8	2.0
Cash and cash equivalents, and other	1.4	1.3	2.8	2.7
<i>Investment income</i>	20.2	21.0	37.6	39.1
Investment expenses	0.5	0.5	1.0	1.1
<i>Net investment income</i>	\$ 19.7	20.5	\$ 36.6	38.0

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

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three and six months ended June 30, 2013 and 2012:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Realized gains:				
Fixed maturities	\$ 0.7	7.5	\$ 1.2	10.7
Equity securities	3.4	2.3	10.0	6.7
<i>Total realized gains</i>	4.1	9.8	11.2	17.4
Realized losses:				
Equity securities:				
Sales	(0.6)	(1.8)	(0.7)	(1.9)
OTTI	(2.0)	(1.1)	(2.3)	(1.5)
Fixed maturities:				
OTTI		(0.2)		(0.2)
<i>Total realized losses</i>	(2.6)	(3.1)	(3.0)	(3.6)
<i>Net realized gain on investments</i>	\$ 1.5	6.7	\$ 8.2	13.8

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Change in unrealized holding gains (losses), net of tax:				
Fixed maturities	\$ (69.3)	4.1	\$ (78.5)	3.5
Equity securities	(0.3)	(6.7)	18.0	4.9
Other invested assets	1.0	(3.6)	4.6	0.4
Deferred federal income tax benefit (liability)	24.0	2.3	19.6	(3.1)
Valuation allowance	(16.7)	(2.0)	(12.0)	3.4
<i>Change in net unrealized holding gains (losses), net of tax</i>	\$ (61.3)	(5.9)	\$ (48.3)	9.1

There was a deferred federal income tax liability, net of a valuation allowance, on the net unrealized holding gains at June 30, 2013 and December 31, 2012 of \$44.9 million and \$52.5 million, respectively.

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3. Fair Value of Financial Instruments

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

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

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

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

The Company utilizes one nationally recognized pricing service to estimate the majority of its available-for-sale investment portfolio's fair value. The Company obtains one price per security and the processes and control procedures employed by the Company are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company gains an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, the Company compares to other fair value pricing information gathered from other independent pricing sources. At June 30, 2013 and December 31, 2012, 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 June 30, 2013 and 2012.

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

Fixed Maturities

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

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determines the fair values by employing widely accepted pricing valuation models, and depending on the level of observable market inputs, renders the fair value estimate as Level 2 or Level 3. The Company holds two fixed maturity corporate securities included in Level 3. The Company estimates the fair value of one security using the present value of the future cash flows and the Company obtains a broker quote of the other security's fair value. Due to the limited amount of observable market information for both of these securities, the Company includes the fair value estimates in Level 3.

Equities

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

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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 \$63.4 million and \$59.0 million at June 30, 2013 and December 31, 2012, respectively, which was determined using each fund s net asset value. The Company employs procedures to assess the reasonableness of the fair value of the funds including obtaining and reviewing each fund s audited financial statements. There are no unfunded commitments related to the funds. The Company may not sell its investment in the funds; however, the Company may redeem all or a portion of its investment in the funds at net asset value per share with the appropriate prior written notice. Due to the Company s ability to redeem its investment in the funds at net asset value per share at the measurement date, the funds have been disclosed in Level 2.

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

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The following tables set forth the Company's available-for-sale investments within the fair value hierarchy at June 30, 2013 and December 31, 2012:

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
At June 30, 2013:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 328.5		328.5	
Obligations of states and political subdivisions	819.6		819.6	
Corporate securities	325.4		316.6	8.8
U.S. government agencies residential mortgage-backed securities	347.4		347.4	
<i>Total fixed maturities</i>	1,820.9		1,812.1	8.8
Equity securities:				
Large-cap securities	187.9	187.9		
Small-cap securities	61.0	61.0		
<i>Total equity securities</i>	248.9	248.9		
Other invested assets	69.2	5.8	63.4	
<i>Total available-for-sale investments</i>	\$ 2,139.0	254.7	1,875.5	8.8

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
At December 31, 2012:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 366.5		366.5	
Obligations of states and political subdivisions	800.3		800.3	
Corporate securities	338.6		330.1	8.5
	399.7		399.7	

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U.S. government agencies residential mortgage-backed securities				
<i>Total fixed maturities</i>	1,905.1		1,896.6	8.5
Equity securities:				
Large-cap securities	174.2	174.2		
Small-cap securities	54.2	54.2		
<i>Total equity securities</i>	228.4	228.4		
Other invested assets	64.4	5.4	59.0	
<i>Total available-for-sale investments</i>	\$ 2,197.9	233.8	1,955.6	8.5

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For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), the following tables set forth a reconciliation of the beginning and ending balances for the three and six months ended June 30, 2013 and the year ended December 31, 2012, separately for each major category of assets:

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2013	\$ 8.5
Total realized gains (losses) included in earnings	
Total unrealized gains (losses) included in other comprehensive income	
Purchases	0.1
Sales	
Transfers into Level 3	
Transfers out of Level 3	
Balance at March 31, 2013	\$ 8.6
Total realized gains (losses) included in earnings	
Total unrealized gains (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, 2013	\$ 8.8

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

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

Notes Receivable from Affiliates

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

(\$ millions, except interest rates)

	June 30, 2013			December 31, 2012		
	Carrying value	Fair value	Interest rate	Carrying value	Fair value	Interest rate
Notes receivable from affiliate	\$ 70.0	\$ 75.5	7.00%	\$ 70.0	\$ 78.3	7.00%

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Notes Payable

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

(\$ millions, except interest rates)

	June 30, 2013			December 31, 2012		
	Carrying value	Fair Value	Interest rate	Carrying value	Fair value	Interest rate
Senior Notes due 2013: issued \$100.0, November 2003 with fixed interest	\$ 100.2	\$ 102.0	6.25%	\$ 100.4	\$ 100.3	6.25%
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.5	15.5	4.47	15.5	15.5	4.51
Total notes payable	\$ 115.7	\$ 117.5		\$ 115.9	\$ 115.8	

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 Automobile Mutual Insurance Company (State Auto Mutual) and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin, Meridian Citizens Mutual Insurance Company, Meridian Security Insurance Company, Patrons Mutual Insurance Company of Connecticut (which includes Litchfield Mutual Fire Insurance Company as it was merged with Patrons Mutual at the close of business March 31, 2013), Rockhill Insurance Company (RIC), Plaza Insurance Company (Plaza), American Compensation Insurance Company (American Compensation) and Bloomington Compensation Insurance Company (Bloomington Compensation), (collectively referred to as the Mutual Pooled Companies).

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, 2013 and 2012:

(\$ millions)

	Three months ended		Six months ended	
	June 30 2013	2012	June 30 2013	2012
Premiums earned:				
Assumed from external insurers and reinsurers	\$ 1.1	1.0	\$ 1.5	2.0
Assumed under Pooling Arrangement	263.5	258.4	524.8	513.3
Ceded to external insurers and reinsurers	(6.7)	(8.1)	(12.2)	(15.5)
Ceded under Pooling Arrangement	(213.1)	(199.8)	(423.8)	(396.7)

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<i>Net assumed premiums earned</i>	\$ 44.8	51.5	\$ 90.3	103.1
Losses and loss expenses incurred:				
Assumed from external insurers and reinsurers	\$ 0.6	1.0	\$ 0.4	1.9
Assumed under Pooling Arrangement	186.9	202.1	360.6	393.6
Ceded to external insurers and reinsurers	(3.1)	1.2	(4.1)	(4.6)
Ceded under Pooling Arrangement	(164.4)	(167.7)	(296.2)	(323.8)
<i>Net assumed losses and loss expenses incurred</i>	\$ 20.0	36.6	\$ 60.7	67.1

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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, 2013 and 2012:

(\$ millions)	Three months ended June 30				Six months ended June 30			
	2013	%	2012	%	2013	%	2012	%
Amount at statutory rate	\$ 2.2	35	\$ (0.9)	35	\$ 9.2	35	\$ (1.6)	35
Tax-exempt interest and dividends received deduction	(2.4)	(38)	(2.2)	79	(4.7)	(18)	(4.4)	94
Other, net	0.1	1	0.3	(11)	0.3	1	0.3	(9)
Valuation allowance	0.2	3	2.8	(103)	(4.4)	(17)	5.7	(120)
<i>Federal income tax expense and effective rate</i>	\$ 0.1	1	\$	\$	\$ 0.4	1	\$	\$

The following table sets forth the tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities at June 30, 2013 and December 31, 2012:

(\$ millions)	June 30, 2013	December 31, 2012
Deferred tax assets:		
Unearned premiums not currently deductible	\$ 35.0	33.4
Losses and loss expenses payable discounting	25.6	25.2
Postretirement and pension benefits	37.6	39.4
Realized loss on other-than-temporary impairment	8.7	7.5
Other liabilities	15.6	14.5
Net operating loss carryforward	62.4	66.5
Tax credit carryforward	1.3	0.9
Other	7.2	7.9
<i>Total deferred tax assets</i>	193.4	195.3
Deferred tax liabilities:		
Deferral of policy acquisition costs	35.1	32.1
Net unrealized holding gains on investments	42.2	61.7
<i>Total deferred tax liabilities</i>	77.3	93.8

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<i>Total net deferred tax assets before valuation allowance</i>	116.1	101.5
Less valuation allowance	107.5	100.5
<i>Net deferred federal income taxes</i>	\$ 8.6	1.0

Deferred income tax assets and liabilities represent the tax effect of the differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. In accordance with the Financial Accounting Standards Board's Accounting Standards Codification 740, Income Taxes (ASC 740), the Company periodically evaluates its deferred tax assets, which requires significant judgment, to determine if they are realizable based upon weighing all available evidence, both positive and negative, including loss carryback potential, past operating results, existence of cumulative losses in the most recent years, projected performance of the business, future taxable income, including the ability to generate capital gains, and prudent and feasible tax planning strategies. In making such judgments, significant weight is given to evidence that can be objectively verified. At June 30, 2013 and December 31, 2012 the Company recorded a valuation allowance of \$107.5 million and \$100.5 million, respectively. The deferred income tax asset remaining after recognition of the valuation allowance represents a deferred tax asset on the gross unrealized fixed maturity losses where management determined this portion of the asset to be realizable due to management's assertion that it has both the ability and intent to hold these securities through recovery or maturity.

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Based on ASC 740 intraperiod tax allocation guidelines, the following sets forth the change in valuation allowance attributable to continuing operations and other comprehensive income for the three and six months ended June 30, 2013 is as follows:

<i>(\$ millions)</i>	Three months ended June 30, 2013	Six months ended June 30, 2013
Continuing operations	\$ 0.2	(4.4)
Other comprehensive income	16.5	11.4
<i>Change in valuation allowance</i>	\$ 16.7	7.0

In future periods the Company will re-assess its judgments and assumptions regarding the realization of its net deferred tax assets, but until such time the positive evidence exceeds the negative evidence the Company will maintain a valuation allowance against its net deferred tax assets.

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, 2013 and 2012:

<i>(\$ millions)</i>	Pension		Postretirement		Pension		Postretirement	
	Three months ended June 30		Six months ended June 30		Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012	2013	2012	2013	2012
Service cost	\$ 1.5	1.9	\$ 0.3	0.4	\$ 3.0	3.8	\$ 0.1	0.6
Interest cost	2.4	2.5	0.3	0.4	4.8	5.0	0.6	0.6
Expected return on plan assets	(3.0)	(2.9)	(0.1)	(0.1)	(6.0)	(5.8)	(0.2)	(0.2)
Amortization of:								
Prior service (benefits) costs		0.1	(1.4)	(1.4)		0.1	(2.8)	(2.7)
Transition assets			0.1				0.2	0.1
Net loss	2.0	1.7	0.2	0.2	4.0	3.4	0.4	0.4
<i>Net periodic cost</i>	\$ 2.9	3.3	\$ (0.8)	(0.9)	\$ 5.8	6.5	\$ (1.5)	(1.8)

The Company contributed \$6.5 million for the six months ended June 30, 2013 and expects to contribute an additional \$6.5 million to the pension plan during 2013.

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7. Other Comprehensive Income and Accumulated Other Comprehensive Income

The following tables set 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, 2013 and 2012:

(\$ millions)

	Unrealized Gains and Losses on Available-for-Sale Securities	Gains and Losses on Cash Flow Hedges	Benefit Plan Items	Total
The three months ended June 30, 2013 and 2012:				
Beginning balance at April 1, 2013	\$ 137.0	0.1	(39.0)	98.1
Other comprehensive income before reclassifications	(59.8)			(59.8)
Amounts reclassified from AOCI ^(a)	(1.5)	(0.1)	0.9	(0.7)
Net current period other comprehensive income	(61.3)	(0.1)	0.9	(60.5)
<i>Ending balance at June 30, 2013</i>	\$ 75.7		(38.1)	37.6
Beginning balance at April 1, 2012	\$ 113.7	0.2	(34.4)	79.5
Other comprehensive income before reclassifications	0.8			0.8
Amounts reclassified from AOCI ^(a)	(6.7)	(0.1)	0.6	(6.2)
Net current period other comprehensive income	(5.9)	(0.1)	0.6	(5.4)
<i>Ending balance at June 30, 2012</i>	\$ 107.8	0.1	(33.8)	74.1

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

(\$ millions)

	Unrealized Gains and Losses on Available-for-Sale Securities	Gains and Losses on Cash Flow Hedges	Benefit Plan Items	Total
--	--	--	-----------------------	-------

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The six months ended June 30, 2013 and 2012:

Beginning balance at January 1, 2013	\$	124.0	0.1	(39.9)	84.2
Other comprehensive income before reclassifications		(40.1)			(40.1)
Amounts reclassified from AOCI ^(a)		(8.2)	(0.1)	1.8	(6.5)
Net current period other comprehensive income		(48.3)	(0.1)	1.8	(46.6)
<i>Ending balance at June 30, 2013</i>	\$	75.7		(38.1)	37.6
Beginning balance at January 1, 2012	\$	98.7	0.2	(35.1)	63.8
Other comprehensive income before reclassifications		22.9			22.9
Amounts reclassified from AOCI ^(a)		(13.8)	(0.1)	1.3	(12.6)
Net current period other comprehensive income		9.1	(0.1)	1.3	10.3
<i>Ending balance at June 30, 2012</i>	\$	107.8	0.1	(33.8)	74.1

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

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The following tables set forth the reclassifications out of accumulated other comprehensive income, by component, to the Company's consolidated statement of income for the three and six months ended June 30, 2013 and 2012:

(\$ millions)

Details about Accumulated Other Comprehensive Income Components	Three months ended		Affected line item in the Condensed Consolidated Statements of Income
	June 30, 2013	June 30, 2012	
Unrealized gains and losses on available for sale securities	\$ 1.5	6.7	Realized gain/(loss) on sale of securities
	1.5	6.7	Total before tax
			Tax (expense) benefit
	1.5	6.7	Net of tax
Amortization of gain on derivative used in cash flow hedge	0.1	0.1	Realized gain/(loss) on sale of securities
	0.1	0.1	Total before tax
			Tax (expense) benefit
	0.1	0.1	Net of tax
Amortization of benefit plan items			
Transition asset	(0.1)		(a)
Negative prior-service costs	1.4	1.3	(a)
Net actuarial loss	(2.2)	(1.9)	(a)
	(0.9)	(0.6)	Total before tax
			Tax (expense) benefit
	(0.9)	(0.6)	Net of tax
<i>Total reclassifications for the period</i>	\$ 0.7	6.2	

(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).

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(\$ millions)

Details about Accumulated Other Comprehensive Income Components	Six months ended		Affected line item in the Condensed Consolidated Statements of Income
	2013	2012	
Unrealized gains and losses on available for sale securities	\$ 8.2	13.8	Realized gain/(loss) on sale of securities
	8.2	13.8	Total before tax
			Tax (expense) benefit
	8.2	13.8	Net of tax
Amortization of gain on derivative used in cash flow hedge	0.1	0.1	Realized gain/(loss) on sale of securities
	0.1	0.1	Total before tax
			Tax (expense) benefit
	0.1	0.1	Net of tax
Amortization of benefit plan items			
Transition asset	(0.2)	(0.1)	(a)
Negative prior-service costs	2.8	2.6	(a)
Net actuarial loss	(4.4)	(3.8)	(a)
	(1.8)	(1.3)	Total before tax
			Tax (expense) benefit
	(1.8)	(1.3)	Net of tax
<i>Total reclassifications for the period</i>	\$ 6.5	12.6	

^(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).

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8. Earnings (Loss) per Common Share

The following table sets forth the compilation of basic and diluted earnings (loss) per common share for the three and six months ended June 30, 2013 and 2012:

(\$ millions, except per share amounts)

	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Numerator:				
Net income (loss) for basic earnings (loss) per common share	\$ 6.2	(2.7)	\$ 25.9	(4.7)
Denominator:				
Weighted average shares for basic net earnings (loss) per common share	40.5	40.3	40.5	40.3
<i>Adjusted weighted average shares for diluted net earnings (loss) per common share</i>	40.8	40.3	40.7	40.3
Basic net earnings (loss) per common share	\$ 0.15	(0.07)	\$ 0.64	(0.12)
Diluted net earnings (loss) per common share	\$ 0.15	(0.07)	\$ 0.64	(0.12)

The following table sets forth the options to purchase shares of common stock that were not included in the computation of diluted earnings per common share because the exercise price of the options was greater than the average market price or their inclusion would have been antidilutive for the three and six months ended June 30, 2013 and 2012:

(number of options in millions)

	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Number of options	2.8	3.8	3.3	3.7

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 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, including workers compensation for both legacy State Auto Group and RTW, Inc.'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

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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 accounting for pension benefits also contributes to the difference between our GAAP loss and expense ratios and our SAP loss and expense ratios. At January 1, 2013, we adopted new SAP pension guidance, which required the recognition of service costs for non-vested participants. In accordance with GAAP, service costs related to non-vested participants was recognized over the vesting period.

The investment operations segment is evaluated based on investment returns of assets managed by Stateco.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Asset information by segment is not reported for the insurance segments because the Company does not produce such information internally.

As of January 1, 2013 our units within the specialty insurance segment changed from RED, Rockhill and Workers Compensation to Excess & Surplus Property, Excess & Surplus Casualty, Programs and Workers Compensation. This change did not have any impact on segment reporting.

The following table sets forth financial information regarding the Company's reportable segments for the three and six months ended June 30, 2013 and 2012:

<i>(\$ millions)</i>	Three months ended June 30		Six months ended June 30	
	2013	2012	2013	2012
Revenues from external sources:				
Insurance segments				
Personal insurance	\$ 117.2	117.2	\$ 231.9	234.7
Business insurance	89.6	79.4	178.1	156.7
Specialty insurance	56.7	61.8	114.8	121.9
<i>Total insurance segments</i>	263.5	258.4	524.8	513.3
Investment operations segment				
Net investment income	19.7	20.5	36.6	38.0
Net realized capital gains	1.5	6.7	8.2	13.8
<i>Total investment operations segment</i>	21.2	27.2	44.8	51.8
All other	0.6	1.1	1.0	1.9
<i>Total revenues from external sources</i>	285.3	286.7	570.6	567.0
Intersegment revenues:	(1.3)	2.3	(2.6)	4.8
<i>Total revenues</i>	284.0	289.0	568.0	571.8
Reconciling items:				
Eliminate intersegment revenues	1.3	(2.3)	2.6	(4.8)
<i>Total consolidated revenues</i>	\$ 285.3	286.7	\$ 570.6	567.0
Segment loss before federal income tax:				
Insurance segments				
Personal insurance SAP underwriting loss	\$ (6.8)	(10.7)	\$ (5.5)	(11.6)
Business insurance SAP underwriting loss	(4.5)	(16.7)	(9.8)	(33.4)
Specialty insurance SAP underwriting loss	(6.0)	(0.1)	(7.7)	(12.4)

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<i>Total insurance segments</i>	(17.3)	(27.5)	(23.0)	(57.4)
Investment operations segment				
Net investment income	19.7	20.5	36.6	38.0
Net realized capital gains	1.5	6.7	8.2	13.8
<i>Total investment operations segment</i>	21.2	27.2	44.8	51.8
All other	0.5	0.6	0.8	1.1
<i>Total segment income (loss) before tax expense (benefit)</i>	4.4	0.3	22.6	(4.5)
Reconciling items:				
GAAP expense adjustments	7.2	0.1	11.8	5.4
Interest expense on corporate debt	(3.8)	(1.7)	(5.5)	(3.5)
Corporate expenses	(1.5)	(1.4)	(2.6)	(2.1)
<i>Total reconciling items</i>	1.9	(3.0)	3.7	(0.2)
<i>Total consolidated income (loss) before federal income tax expense (benefit)</i>	\$ 6.3	(2.7)	\$ 26.3	(4.7)

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Investable assets attributable to the Company's investment operations segment totaled \$2,278.0 million and \$2,327.4 million at June 30, 2013 and December 31, 2012, respectively.

10. Contingencies and Litigation

In accordance with the Contingencies Topic of the FASB ASC, the Company accrues for a litigation-related liability when it is probable that such a liability has been incurred and the amount can be reasonably estimated. 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 State Auto Financial Corporation.

The following describes a pending legal proceeding, other than routine litigation incidental to our business, to which State Auto Financial or any of its subsidiaries is a party or to which any of its or their property is subject:

In April 2013, a putative class action lawsuit (Schumacher vs. State Automobile Mutual Insurance Company, et al.) was filed against State Auto Mutual, State Auto Financial and State Auto P&C in Federal District Court in Ohio. Plaintiffs claim that in connection with the homeowners policies of various State Auto companies, the coverage limits and premiums were improperly increased as a result of an insurance to value (ITV) program and Plaintiffs allege that they purchased coverage in excess of that which was necessary to insure them in the event of loss. Plaintiffs claims include breach of good faith and fair dealing, negligent misrepresentation and fraud, violation of the Ohio Deceptive Trade Practices Act, and fraudulent inducement. Plaintiffs are seeking class certification and compensatory and punitive damages to be determined by the court. The Company intends to deny any and all liability to plaintiffs or the alleged class and to vigorously defend this lawsuit.

The Company is involved in other lawsuits arising in the ordinary course of our business operations arising out of or otherwise related to our insurance policies. Additionally, from time to time the Company may be involved in lawsuits arising in the ordinary course of business but not arising out of or otherwise related to its insurance policies. 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 or cash flow positions.

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.

11. Subsequent Events

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On July 11, 2013, State Auto P&C received a loan (the 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, in the principal amount of \$85.0 million. 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.

On July 15, 2013, the Company completed the redemption of all of its outstanding \$100.0 million 6.25% Senior Notes due 2013. The total redemption price paid by the Company was \$103.0 million, which included interest through the redemption date and a make whole amount due to the Senior Notes being redeemed prior to their November 15, 2013 maturity date. The redemption price was funded by proceeds from the FHLB Loan and cash on hand.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

On July 26, 2013, State Auto Financial terminated its then-current credit agreement with a syndicate of lenders, as further described below. Concurrently with the termination of this credit agreement, State Auto P&C entered into a new credit facility (the New Credit Facility) with a syndicate of lenders. The New Credit Facility provides State Auto P&C with a \$100.0 million five-year revolving credit facility maturing in July 2018. During the term of the New 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 New 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 New Credit Agreement are to be fully secured by a pledge of specific investment securities of State Auto P&C. The New Credit Facility includes certain covenants, including financial covenants that require State Auto Financial to maintain a minimum net worth and not exceed a certain debt to capitalization ratio.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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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 "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, 2012 (the "2012 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, 2013 and December 31, 2012, and for the consolidated statements of income for the three and six-month periods ended June 30, 2013 and 2012. This discussion and analysis should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the 2012 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 2012 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 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 2012 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. Effective January 1, 2013, the units within the specialty insurance segment changed from the three units of RED, Rockhill and Workers' Compensation to the four units of Excess & Surplus property, Excess & Surplus casualty, Programs and Workers' compensation. 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 2012 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2013 is set forth in Note 9 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

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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.

The following table sets forth the participants and their participation percentages in the Pooling Arrangement since January 1, 2012:

STFC Pooled Companies:	
State Auto P&C	51.0%
Milbank	14.0
SA Ohio	0.0
<i>Total STFC Pooled Companies</i>	<i>65.0</i>
State Auto Mutual Pooled Companies:	
State Auto Mutual	34.0
SA Wisconsin	0.0
Meridian Security	0.0
Meridian Citizens Mutual	0.5
Patrons Mutual ⁽¹⁾	0.5
RIC	0.0
Plaza	0.0
American Compensation	0.0
Bloomington Compensation	0.0
<i>Total State Auto Mutual Pooled Companies</i>	<i>35.0</i>

⁽¹⁾ Includes the pooling participation percentage of Litchfield which was merged into Patrons Mutual as of the close of business on March 31, 2013. Litchfield's pooling participation percentage was 0.1% from January 1, 2012 to March 31, 2013.

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RESULTS OF OPERATIONS

Our net income for the three and six months ended June 30, 2013 was \$6.2 million and \$25.9 million, respectively, compared to net losses of \$2.7 million and \$4.7 million, respectively, for the same 2012 periods. The improvement in our 2013 results, when compared to 2012, was primarily due to a decrease in the level of catastrophe losses and an improvement in the level of our non-catastrophe losses during the first half of 2013. Year over year results have been impacted by the termination of business previously written through our former RED unit in our specialty insurance segment.

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The following table sets forth certain key performance indicators we use to monitor our operations for the three and six months ended June 30, 2013 and 2012:

(\$ millions, except per share amounts)

	Three months ended		Six months ended	
	June 30		June 30	
<u>GAAP Basis:</u>	2013	2012	2013	2012
Total revenues	\$ 285.3	286.7	\$ 570.6	567.0
Net income (loss)	\$ 6.2	(2.7)	\$ 25.9	(4.7)
Basic earnings (loss) per share	\$ 0.15	(0.07)	\$ 0.64	(0.12)
Diluted earnings (loss) per share	\$ 0.15	(0.07)	\$ 0.64	(0.12)
Stockholders' equity	\$ 711.3	719.7		
Return on average equity (LTM)	5.8%	5.3		
Book value per share	\$ 17.53	17.82		
Debt to capital ratio	14.0	13.9		
Cat loss and ALAE ratio	8.1	13.2	4.9	10.5
Non-cat loss and LAE ratio	62.5	64.9	63.5	66.1
Loss and LAE ratio	70.6	78.1	68.4	76.6
Expense ratio	33.0	32.3	33.5	33.3
Combined ratio	103.6	110.4	101.9	109.9
Premium written growth	5.8%	(30.4)	3.0%	(30.3)
Investment yield	3.7%	3.9	3.4%	3.5

	Three months ended		Six months ended	
	June 30		June 30	
<u>SAP Basis :</u>	2013	2012	2013	2012
Cat loss and ALAE points	8.1	13.2	4.9	10.5
Non-cat loss and ALAE	56.2	57.4	57.4	58.8
ULAE	6.6	7.5	6.4	7.4
Loss and LAE ratio	70.9	78.1	68.7	76.7
Expense ratio	33.0	31.3	34.1	33.3
Combined ratio	103.9	109.4	102.8	110.0

	Twelve months ended	
	June 30	
	2013	2012
Net premiums written to surplus	1.6	1.9

Homeowners Quota Share Arrangement

To reduce risk and volatility in our homeowners book of business, while at the same time providing us with additional catastrophe reinsurance protection, the State Auto Group entered into a quota share reinsurance agreement on December 31, 2011 with a syndicate of unaffiliated reinsurers covering its homeowners book of business (the HO QS Arrangement). Under the HO QS Arrangement, the State Auto Group ceded to the reinsurers 75% of its homeowners business under policies in force at December 31, 2011 and new and renewal policies thereafter issued during the term of the agreement. The HO QS Arrangement is in effect until December 31, 2014. See Management's Discussion and Analysis of

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Financial Condition and Results of Operations Liquidity and Capital Resources Reinsurance Arrangements in Item 7 of the 2012 Form 10-K
for a discussion of the HO QS Arrangement.

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The following tables set forth, on a GAAP and pro forma basis, certain of our key performance indicators before and after the impact of the HO QS Arrangement cession for the three and six months ended June 30, 2013 and 2012.

Reconciliation Table 1

Three months ended June 30, 2013

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results		
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession
Net written premiums	\$ 285.1	\$ 49.4	\$ 334.5
Earned premiums	263.5	43.5	307.0
Losses and LAE incurred:			
Cat loss and ALAE	21.2	12.2	33.4
Non-cat loss and LAE	164.9	22.0	186.9
<i>Total Loss and LAE incurred</i>	186.1	34.2	220.3
Acquisition and operating expenses	87.0	12.6	99.6
<i>Net underwriting loss</i>	\$ (9.6)	\$ (3.3)	\$ (12.9)
Cat loss and ALAE ratio	8.1%	28.0%	10.9%
Non-cat loss and LAE ratio	62.5%	50.6%	60.9%
<i>Total Loss and LAE ratio</i>	70.6%	78.6%	71.8%
Expense ratio	33.0%	29.0%	32.4%
<i>Combined ratio</i>	103.6%	107.6%	104.2%

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Reconciliation Table 2

Six months ended June 30, 2013

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results		
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession
Net written premiums	\$ 548.8	\$ 87.3	\$ 636.1
Earned premiums	524.8	88.9	613.7
Losses and LAE incurred:			
Cat loss and ALAE	25.8	14.2	40.0
Non-cat loss and LAE	333.3	39.3	372.6
<i>Total Loss and LAE incurred</i>	359.1	53.5	412.6
Acquisition and operating expenses	175.8	25.8	201.6
<i>Net underwriting (loss) gain</i>	\$ (10.1)	\$ 9.6	\$ (0.5)