

State Auto Financial CORP  
Form 10-Q  
August 05, 2010

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

**FORM 10-Q**

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

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

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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 30, 2010, the Registrant had 40,067,233 Common Shares outstanding.

**Index to Form 10-Q Quarterly Report for the three and six month periods ended June 30, 2010**

**Part I. Financial Information**

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## PART I FINANCIAL STATEMENTS

## Item 1. Condensed Consolidated Balance Sheets

(\$ millions, except per share amount)

|  | June 30<br>2010<br>(unaudited) | December 31<br>2009<br>(see note 1) |
|--|--------------------------------|-------------------------------------|
| <b>Assets</b>  |                                |                                     |
| Fixed maturities, available-for-sale, at fair value (amortized cost \$1,806.6 and \$1,788.1, respectively)                               | \$ 1,875.0                     | 1,831.8                             |
| Equity securities, available-for-sale, at fair value (cost \$216.1 and \$189.7, respectively)  | 230.7                          | 224.1                               |
| Other invested assets, available-for-sale, at fair value (cost \$60.1 and \$44.1, respectively)  | 63.0                           | 52.3                                |
| Other invested assets  | 1.0                            | 0.9                                 |
| Notes receivable from affiliate  | 70.0                           | 70.0                                |
| <i>Total investments</i>   | <b>2,239.7</b>                 | 2,179.1                             |
| Cash and cash equivalents  | 66.0                           | 90.3                                |
| Accrued investment income and other assets   | 27.8                           | 35.1                                |
| Deferred policy acquisition costs  | 139.0                          | 127.3                               |
| Reinsurance recoverable on losses and loss expenses payable (affiliates \$0.0 and \$0.1, respectively)                                   | 16.7                           | 20.8                                |
| Prepaid reinsurance premiums (affiliates none)   | 7.5                            | 7.2                                 |
| Due from affiliate   | 30.9                           | 7.7                                 |
| Current federal income taxes   | 22.5                           | 9.1                                 |
| Net deferred federal income taxes  | 79.5                           | 75.9                                |
| Property and equipment, at cost  | 11.8                           | 12.0                                |
| <b>Total assets</b>  | <b>\$ 2,641.4</b>              | 2,564.5                             |
| <b>Liabilities and Stockholders Equity</b>   |                                |                                     |
| Losses and loss expenses payable (affiliates \$370.9 and \$346.2, respectively)  | \$ 887.1                       | 840.2                               |
| Unearned premiums (affiliates \$207.3 and \$180.7, respectively)   | 589.6                          | 547.0                               |
| Notes payable (affiliates \$15.5 and \$15.5, respectively)   | 117.0                          | 117.2                               |
| Postretirement and pension benefits  | 174.8                          | 150.4                               |
| Other liabilities  | 57.9                           | 60.3                                |
| <b>Total liabilities</b>   | <b>1,826.4</b>                 | 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; 46.8 and 46.6 shares issued, respectively, at stated value of \$2.50 per share | 117.0                          | 116.6                               |
| Treasury stock, 6.8 and 6.8 shares, respectively, at cost  | (115.8)                        | (115.7)                             |
| Additional paid-in capital   | 119.8                          | 115.8                               |
| Accumulated other comprehensive loss   | (16.3)                         | (2.9)                               |

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|   |                   |         |
|---|-------------------|---------|
| Retained earnings                                       | <b>710.3</b>      | 735.6   |
| <b><i>Total stockholders equity</i></b>                 | <b>815.0</b>      | 849.4   |
| <b><i>Total liabilities and stockholders equity</i></b> | <b>\$ 2,641.4</b> | 2,564.5 |

See accompanying notes to condensed consolidated financial statements.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Condensed Consolidated Statements of Income**

| <i>(\$ millions, except per share amounts)</i>                                   | Three months ended<br>June 30 |        |
|--|-------------------------------|--------|
| (unaudited)  | <b>2010</b>                   | 2009   |
| Earned premiums (ceded to affiliates \$204.6 and \$184.2, respectively)          | <b>\$ 309.3</b>               | 292.6  |
| Net investment income (affiliates \$1.2 and \$0.7, respectively)                 | <b>20.8</b>                   | 20.8   |
| Net realized gain (loss) on investments:   |                               |        |
| Total other-than-temporary impairment losses                                     | <b>(1.6)</b>                  | (0.6)  |
| Portion of loss recognized in other comprehensive income                         |                               |        |
| Other net realized investment gains (losses)                                     | <b>1.9</b>                    | 3.1    |
| Total net realized gain on investments   | <b>0.3</b>                    | 2.5    |
| Other income (affiliates \$0.4 and \$0.5, respectively)                          | <b>0.7</b>                    | 1.0    |
| <b>Total revenues</b>  | <b>331.1</b>                  | 316.9  |
| Losses and loss expenses (ceded to affiliates \$159.5 and \$150.1, respectively) | <b>252.1</b>                  | 225.5  |
| Acquisition and operating expenses   | <b>104.3</b>                  | 98.0   |
| Interest expense (affiliates \$0.2 and \$0.2, respectively)                      | <b>1.8</b>                    | 1.8    |
| Other expenses   | <b>2.9</b>                    | 3.3    |
| <b>Total expenses</b>  | <b>361.1</b>                  | 328.6  |
| <b>Loss before federal income taxes</b>  | <b>(30.0)</b>                 | (11.7) |
| Federal income tax benefit   | <b>(3.8)</b>                  | (8.5)  |
| <b>Net loss</b>  | <b>\$ (26.2)</b>              | (3.2)  |
| Loss per common share:   |                               |        |
| Basic  | <b>\$ (0.66)</b>              | (0.08) |
| Diluted  | <b>\$ (0.66)</b>              | (0.08) |
| Dividends paid per common share  | <b>\$ 0.15</b>                | 0.15   |

See accompanying notes to condensed consolidated financial statements.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Condensed Consolidated Statements of Income**

| <i>(\$ millions, except per share amounts)</i>                                   | Six months ended<br>June 30 |        |
|--|-----------------------------|--------|
| (unaudited)  | 2010                        | 2009   |
| Earned premiums (ceded to affiliates \$406.3 and \$364.1, respectively)          | \$ 611.6                    | 578.6  |
| Net investment income (affiliates \$2.4 and \$0.7, respectively)                 | 41.3                        | 39.1   |
| Net realized gain (loss) on investments:   |                             |        |
| Total other-than-temporary impairment losses                                     | (2.4)                       | (7.0)  |
| Portion of loss recognized in other comprehensive income                         |                             |        |
| Other net realized investment gains (losses)                                     | 5.9                         | (1.8)  |
| Total net realized gain (loss) on investments                                    | 3.5                         | (8.8)  |
| Other income (affiliates \$0.9 and \$1.2, respectively)                          | 1.1                         | 2.0    |
| <b>Total revenues</b>  | <b>657.5</b>                | 610.9  |
| Losses and loss expenses (ceded to affiliates \$293.6 and \$289.8, respectively) | 452.1                       | 450.3  |
| Acquisition and operating expenses   | 205.5                       | 193.4  |
| Interest expense (affiliates \$0.4 and \$0.4, respectively)                      | 3.6                         | 3.8    |
| Other expenses   | 5.7                         | 6.0    |
| <b>Total expenses</b>  | <b>666.9</b>                | 653.5  |
| <b>Loss before federal income taxes</b>  | <b>(9.4)</b>                | (42.6) |
| Federal income tax expense (benefit)   | 3.9                         | (25.4) |
| <b>Net loss</b>  | <b>\$ (13.3)</b>            | (17.2) |
| Loss per common share:   |                             |        |
| Basic  | \$ (0.33)                   | (0.44) |
| Diluted  | \$ (0.33)                   | (0.44) |
| Dividends paid per common share  | \$ 0.30                     | 0.30   |

See accompanying notes to condensed consolidated financial statements.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## Condensed Consolidated Statements of Cash Flows

| <i>(\$ millions)</i>   | Six months ended<br>June 30 |               |
|--|-----------------------------|---------------|
| (unaudited)  | 2010                        | 2009          |
| <b>Cash flows from operating activities:</b>   |                             |               |
| Net loss   | \$ (13.3)                   | (17.2)        |
| Adjustments to reconcile net loss to net cash provided by operating activities:              |                             |               |
| Depreciation and amortization, net   | 3.8                         | 7.5           |
| Share-based compensation   | 2.0                         | 2.0           |
| Net realized (gain) loss on investments  | (3.5)                       | 8.8           |
| Changes in operating assets and liabilities:   |                             |               |
| Deferred policy acquisition costs  | (12.0)                      | (5.4)         |
| Accrued investment income and other assets   | 1.4                         | 0.4           |
| Postretirement and pension benefits  | 4.3                         | (1.2)         |
| Other liabilities and due to/from affiliates, net  | (32.7)                      | (52.0)        |
| Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums | 3.7                         | (2.1)         |
| Losses and loss expenses payable   | 50.9                        | 49.9          |
| Unearned premiums  | 44.1                        | 26.9          |
| Excess tax benefits on share based awards  | 0.3                         |               |
| Federal income taxes   | (9.8)                       | (12.5)        |
| Cash provided from pooling change, January 1, 2010 (Note 4)                                  | 3.7                         |               |
| <b>Net cash provided by operating activities</b>   | <b>42.9</b>                 | <b>5.1</b>    |
| <b>Cash flows from investing activities:</b>   |                             |               |
| Purchases of fixed maturities available-for-sale   | (183.8)                     | (208.0)       |
| Purchases of equity securities available-for-sale  | (65.7)                      | (6.8)         |
| Purchases of other invested assets   | (16.5)                      | (0.4)         |
| Maturities, calls and pay downs of fixed maturities available-for-sale                       | 118.0                       | 47.0          |
| Sales of fixed maturities available-for-sale   | 47.5                        | 179.3         |
| Sales of equity securities available-for-sale  | 42.5                        | 17.5          |
| Sales of other invested assets   | 0.5                         | 0.3           |
| Notes to affiliate   |                             | (70.0)        |
| <b>Net cash used in investing activities</b>   | <b>(57.5)</b>               | <b>(41.1)</b> |
| <b>Cash flows from financing activities:</b>   |                             |               |
| Proceeds from issuance of common stock   | 2.3                         | 1.9           |
| Payment of dividends   | (12.0)                      | (11.9)        |
| <b>Net cash used in financing activities</b>   | <b>(9.7)</b>                | <b>(10.0)</b> |



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|  |                |              |
|--|----------------|--------------|
| Net decrease in cash and cash equivalents                | (24.3)         | (46.0)       |
| Cash and cash equivalents at beginning of period         | 90.3           | 150.5        |
| <b>Cash and cash equivalents at end of period</b>        | <b>\$ 66.0</b> | <b>104.5</b> |
| Supplemental disclosures:                                |                |              |
| Interest paid (affiliates \$0.3 and \$0.5, respectively) | \$ 3.5         | 3.6          |
| Federal income taxes paid (received)                     | \$ 13.4        | (12.9)       |

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 six month period ended June 30, 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.



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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 summarize the cost or amortized cost and fair value of available-for-sale securities at June 30, 2010 and December 31, 2009:

(\$ millions)

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses | Fair<br>value  |
|--|------------------------------|---|--|----------------|
| <b>At June 30, 2010:</b>   |                              |   |  |                |
| Fixed Maturities:  |                              |   |  |                |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 452.9                     | 13.0                                    |  | 465.9          |
| Obligations of states and political subdivisions                     | 957.0                        | 37.4                                    | (0.7)                                    | 993.7          |
| Corporate securities   | 113.5                        | 7.1                                     |  | 120.6          |
| U.S. government agencies residential mortgage-backed securities      | 283.2                        | 12.0                                    | (0.4)                                    | 294.8          |
| <i>Total fixed maturities</i>  | <b>1,806.6</b>               | <b>69.5</b>                             | <b>(1.1)</b>                             | <b>1,875.0</b> |
| Equity securities:   |                              |   |  |                |
| Large-cap equity securities  | 183.1                        | 21.2                                    | (9.6)                                    | 194.7          |
| Small-cap equity securities  | 33.0                         | 3.0                                     |  | 36.0           |
| <i>Total equity securities</i>                                       | <b>216.1</b>                 | <b>24.2</b>                             | <b>(9.6)</b>                             | <b>230.7</b>   |
| Other invested assets  | 60.1                         | 3.5                                     | (0.6)                                    | 63.0           |
| <i>Total available-for-sale securities</i>                           | <b>\$ 2,082.8</b>            | <b>97.2</b>                             | <b>(11.3)</b>                            | <b>2,168.7</b> |

(\$ millions)

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses | Fair<br>value  |
|--|------------------------------|---|--|----------------|
| <b>At December 31, 2009:</b>   |                              |   |  |                |
| 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          |
| <i>Total fixed maturities</i>  | <b>1,788.1</b>               | <b>47.9</b>                             | <b>(4.2)</b>                             | <b>1,831.8</b> |
| Equity securities:   |                              |   |  |                |
| Large-cap equity securities  | 164.7                        | 31.6                                    | (0.2)                                    | 196.1          |
| Small-cap equity securities  | 25.0                         | 3.0                                     |  | 28.0           |
| <i>Total equity securities</i>                                       | <b>189.7</b>                 | <b>34.6</b>                             | <b>(0.2)</b>                             | <b>224.1</b>   |

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|  |            |      |               |
|--|------------|------|---------------|
| Other invested assets                      | 44.1       | 8.2  | 52.3          |
| <i>Total available-for-sale securities</i> | \$ 2,021.9 | 90.7 | (4.4) 2,108.2 |

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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 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 June 30, 2010 and December 31, 2009:

(\$ 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 |
| <b>At June 30, 2010:</b>   |                     |                   |                     |                   |                   |                     |                 |                   |                     |
| <b>Fixed maturities:</b>   |                     |                   |                     |                   |                   |                     |                 |                   |                     |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 11.5             | \$                | 2                   | \$                | \$                |                     | \$ 11.5         | \$                | 2                   |
| Obligations of states and political subdivisions                     | 44.3                | (0.3)             | 17                  | 20.2              | (0.4)             | 8                   | 64.5            | (0.7)             | 25                  |
| U.S. government agencies residential mortgage-backed securities      | 2.9                 |                   | 1                   | 20.2              | (0.4)             | 10                  | 23.1            | (0.4)             | 11                  |
| <b>Total fixed maturities</b>  | <b>58.7</b>         | <b>(0.3)</b>      | <b>20</b>           | <b>40.4</b>       | <b>(0.8)</b>      | <b>18</b>           | <b>99.1</b>     | <b>(1.1)</b>      | <b>38</b>           |
| Large-cap equity securities  | 81.5                | (8.4)             | 31                  | 8.6               | (1.2)             | 5                   | 90.1            | (9.6)             | 36                  |
| Other invested assets  | 30.6                | (0.6)             | 2                   |                   |                   |                     | 30.6            | (0.6)             | 2                   |
| <b>Total temporarily impaired securities</b>                         | <b>\$ 170.8</b>     | <b>\$ (9.3)</b>   | <b>53</b>           | <b>\$ 49.0</b>    | <b>\$ (2.0)</b>   | <b>23</b>           | <b>\$ 219.8</b> | <b>\$ (11.3)</b>  | <b>76</b>           |

(\$ 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 |
| <b>At December 31, 2009:</b>   |                     |                   |                     |                   |                   |                     |            |                   |                     |
| <b>Fixed maturities:</b>   |                     |                   |                     |                   |                   |                     |            |                   |                     |
| 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                  |

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

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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)

Realized losses recognized for the three and six months ended June 30 related to other-than-temporary impairments on the Company's investment portfolio are summarized as follows:

| <i>(\$ millions)</i>                          | Three months ended<br>June 30 |       | Six months ended<br>June 30 |       |
|---|-------------------------------|-------|-----------------------------|-------|
|   | <b>2010</b>                   | 2009  | <b>2010</b>                 | 2009  |
| <b>Equity securities:</b>                     |                               |       |                             |       |
| Large-cap equity securities                   | \$                            | (0.5) | \$ (0.3)                    | (6.1) |
| Small-cap equity securities                   | <b>(1.6)</b>                  | (0.1) | <b>(2.1)</b>                | (0.9) |
| <i>Total other-than-temporary impairments</i> | <b>\$ (1.6)</b>               | (0.6) | <b>\$ (2.4)</b>             | (7.0) |

The Company did not recognize other-than-temporary impairments on its fixed maturity securities for the three and six months ended June 30, 2010 and 2009. The Company reviewed its investments at June 30, 2010 and 2009, and determined no additional other-than-temporary impairments 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 loss. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive 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 June 30, 2010, by contractual maturity, are as follows:

| <i>(\$ millions)</i>               | Amortized<br>cost | Fair<br>value |
|------------------------------------|-------------------|---------------|
| Due in 1 year or less              | \$ 34.1           | 34.2          |
| Due after 1 year through 5 years   | 301.4             | 310.0         |
| Due after 5 years through 10 years | 508.8             | 535.3         |
| Due after 10 years                 | 679.1             | 700.7         |



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|   |            |         |
|---|------------|---------|
| U.S. government agencies residential mortgage-backed securities | 283.2      | 294.8   |
| <i>Total</i>  | \$ 1,806.6 | 1,875.0 |

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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 \$66.4 million and \$56.9 million were on deposit with insurance regulators as required by law at June 30, 2010 and December 31, 2009, respectively.

Components of net investment income for the three and six months ended June 30 are summarized as follows:

| (\$ millions)                        | Three months ended |      | Six months ended |      |
|--------------------------------------|--------------------|------|------------------|------|
|                                      | June 30            | 2009 | June 30          | 2009 |
| Fixed maturities                     | \$ 18.5            | 19.5 | \$ 37.0          | 36.7 |
| Equity securities                    | 1.5                | 0.8  | 2.6              | 1.7  |
| Cash and cash equivalents, and other | 1.4                | 0.8  | 2.7              | 1.3  |
| <i>Investment income</i>             | <b>21.4</b>        | 21.1 | <b>42.3</b>      | 39.7 |
| Investment expenses                  | 0.6                | 0.3  | 1.0              | 0.6  |
| <i>Net investment income</i>         | <b>\$ 20.8</b>     | 20.8 | <b>\$ 41.3</b>   | 39.1 |

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 and six months ended June 30, 2010 were \$37.6 million and \$93.9 million, respectively, and for the three and six months ended June 30, 2009 were \$117.9 million and \$204.8 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 loss and, as such, are not included in the determination of net loss. Realized gains and losses on the sales of investments are computed using the first-in, first-out method.

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 and unrealized holding gains and losses for the three and six months ended June 30 are summarized as follows:

| (\$ millions)  | Three months ended<br>June 30 |       | Six months ended<br>June 30 |        |
|--|-------------------------------|-------|-----------------------------|--------|
|  | 2010                          | 2009  | 2010                        | 2009   |
| <b>Realized gains:</b>                                 |                               |       |                             |        |
| Fixed maturities                                       | \$ 0.2                        | 2.2   | \$ 1.1                      | 3.1    |
| Equity securities                                      | 3.4                           | 1.2   | 7.3                         | 1.3    |
| <i>Total realized gains</i>                            | <b>3.6</b>                    | 3.4   | <b>8.4</b>                  | 4.4    |
| <b>Realized losses:</b>                                |                               |       |                             |        |
| Fixed maturities                                       |                               |       |                             |        |
| Equity securities:                                     |                               |       |                             |        |
| Sales  | (1.7)                         | (0.3) | (2.5)                       | (6.2)  |
| OTTI   | (1.6)                         | (0.6) | (2.4)                       | (7.0)  |
| <i>Total realized losses</i>                           | <b>(3.3)</b>                  | (0.9) | <b>(4.9)</b>                | (13.2) |
| <i>Net realized gain (loss) on investments</i>         | <b>\$ 0.3</b>                 | 2.5   | <b>\$ 3.5</b>               | (8.8)  |
| <b>Change in unrealized holding (losses) gains:</b>    |                               |       |                             |        |
| Fixed maturities                                       | \$ 23.0                       | (1.9) | \$ 24.7                     | 30.6   |
| Equity securities                                      | (25.3)                        | 16.2  | (19.8)                      | 11.4   |
| Other invested assets                                  | (6.4)                         | 6.4   | (5.3)                       | 1.9    |
| Deferred federal income tax liability thereon          | 3.0                           | (7.2) | 0.1                         | (15.4) |
| Valuation allowance                                    |                               |       |                             | 2.6    |
| <i>Change in net unrealized holding (losses) gains</i> | <b>\$ (5.7)</b>               | 13.5  | <b>\$ (0.3)</b>             | 31.1   |

There was a deferred federal income tax liability on the net unrealized holding gains at June 30, 2010 and December 31, 2009, of \$30.1 million and \$30.2 million, respectively.

### 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.

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

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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 six months ended June 30, 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 June 30, 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 \$59.1 million and \$48.3 million at June 30, 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 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.



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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table reflects the Company's available-for-sale investments within the fair value hierarchy at June 30, 2010 and December 31, 2009:

(\$ millions)

|  | Total             | Quoted prices<br>in active<br>markets for<br>identical<br>assets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
|--|-------------------|---|---|--|
| <b>At June 30, 2010:</b>   |                   |   |   |  |
| <b>Fixed maturities:</b>   |                   |   |   |  |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 465.9          |   | 465.9   |  |
| Obligations of states and political subdivisions                     | 993.7             |   | 993.7   |  |
| Corporate securities   | 120.6             |   | 118.0   | 2.6  |
| U.S. government agencies residential mortgage-backed securities      | 294.8             |   | 294.8   |  |
| <i>Total fixed maturities</i>  | <b>1,875.0</b>    |   | <b>1,872.4</b>  | <b>2.6</b>   |
| <b>Equity securities:</b>  |                   |   |   |  |
| Large-cap equity securities  | 194.7             | 194.7   |   |  |
| Small-cap equity securities  | 36.0              | 36.0  |   |  |
| <i>Total equity securities</i>                                       | <b>230.7</b>      | <b>230.7</b>  |   |  |
| Other invested assets  | 63.0              | 3.9   | 59.1  |  |
| <i>Total available-for-sale investments</i>                          | <b>\$ 2,168.7</b> | <b>234.6</b>  | <b>1,931.5</b>  | <b>2.6</b>   |

(\$ millions)

|  | Total    | Quoted prices<br>in active<br>markets for<br>identical<br>assets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
|--|----------|---|---|--|
| <b>At December 31, 2009:</b>   |          |   |   |  |
| <b>Fixed maturities:</b>   |          |   |   |  |
| 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   |  |

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|   |            |       |         |     |
|---|------------|-------|---------|-----|
| <i>Total fixed maturities</i>               | 1,831.8    |       | 1,829.5 | 2.3 |
| <b>Equity securities:</b>                   |            |       |         |     |
| Large-cap equity securities                 | 196.1      | 196.1 |         |     |
| Small-cap equity securities                 | 28.0       | 28.0  |         |     |
| <i>Total equity securities</i>              | 224.1      | 224.1 |         |     |
| Other invested assets                       | 52.3       | 4.0   | 48.3    |     |
| <i>Total available-for-sale investments</i> | \$ 2,108.2 | 228.1 | 1,877.8 | 2.3 |



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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 and six months ended June 30, 2010 and December 31, 2009, separately for each major category of assets is as follows:

| <i>(\$ millions)</i>  | <b>Fixed<br/>maturities</b> |
|---|-----------------------------|
| 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                         |
| Total realized gains and losses   |                             |
| Included in other comprehensive income - total gains or losses unrealized | 0.2                         |
| Purchases, issuances, and settlements                                     |                             |
| Transfers in and/or out of Level 3  |                             |
| Balance at June 30, 2010  | \$ 2.6                      |

| <i>(\$ millions)</i>  | Fixed<br>maturities | Other<br>invested<br>assets |
|---|---------------------|-----------------------------|
| Balance at January 1, 2009  | \$ 2.3              | 28.8                        |
| Total realized gains and losses   |                     | 5.7                         |
| Included in other comprehensive loss - total gains or losses unrealized |                     | 0.9                         |
| Purchases, issuances, and settlements                                   |                     | 1.9                         |
| Transfers in and/or (out) of Level 3                                    |                     | (37.3)                      |
| Balance at December 31, 2009  | \$ 2.3              |                             |

Below is a summary of the carrying value and fair value of financial instruments at June 30, 2010:

| <i>(\$ millions)</i>                                 | Carrying<br>value | Fair<br>value | Reference |
|--|-------------------|---------------|-----------|
| <b>Assets:</b>                                       |                   |               |           |
| Fixed maturities, available-for-sale, at fair value  | \$ 1,875.0        | 1,875.0       | See above |
| Equity securities, available-for-sale, at fair value | 230.7             | 230.7         | See above |

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|  |       |       |            |
|--|-------|-------|------------|
| Other invested assets, available-for-sale, at fair value | 63.0  | 63.0  | See above  |
| Notes receivable from affiliate                          | 70.0  | 71.7  | See Note 5 |
| Liabilities:   |       |       |            |
| Notes payable  | 117.0 | 118.7 | See Note 6 |

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**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.

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)         |
| <i>Net cash received</i>          | <i>\$ 3.7</i> |

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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

| <i>(\$ millions)</i>   | Three months ended<br>June 30 |         | Six months ended<br>June 30 |         |
|--|-------------------------------|---------|-----------------------------|---------|
|  | 2010                          | 2009    | 2010                        | 2009    |
| <b>Premiums earned:</b>  |                               |         |                             |         |
| Assumed from other insurers and reinsurers                     | \$ 0.9                        | 1.5     | \$ 2.0                      | 2.6     |
| Assumed under State Auto Pool and other affiliate arrangements | 309.4                         | 282.5   | 612.0                       | 558.5   |
| Ceded to other insurers and reinsurers                         | (6.8)                         | (6.9)   | (13.3)                      | (13.5)  |
| Ceded under State Auto Pool and other affiliate arrangements   | (204.6)                       | (184.2) | (406.3)                     | (364.1) |
| <i>Net assumed premiums earned</i>                             | <b>\$ 98.9</b>                | 92.9    | <b>\$ 194.4</b>             | 183.5   |
| <b>Losses and loss expenses incurred:</b>                      |                               |         |                             |         |
| Assumed from other insurers and reinsurers                     | \$ 0.7                        | 0.7     | \$ 1.0                      | 0.9     |
| Assumed under State Auto Pool and other affiliate arrangements | 250.7                         | 218.1   | 449.0                       | 433.4   |
| Ceded to other insurers and reinsurers                         | 0.7                           | (7.2)   | 1.0                         | (9.0)   |
| Ceded under State Auto Pool and other affiliate arrangements   | (159.5)                       | (150.1) | (293.6)                     | (289.8) |
| <i>Net assumed losses and loss expenses incurred</i>           | <b>\$ 92.6</b>                | 61.5    | <b>\$ 157.4</b>             | 135.5   |

### 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 these agreements, State Auto Financial earned interest of \$1.2 million and \$2.4 million for the three and six months ended June 30, 2010, respectively, and \$0.7 million for both the three and six months ended June 30, 2009. 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 June 30, 2010 and December 31, 2009, consisted of the following:

| <i>(\$ millions, except interest rates)</i> | June 30, 2010     |               |                  | December 31, 2009 |               |                  |
|---|-------------------|---------------|------------------|-------------------|---------------|------------------|
|   | Carrying<br>value | Fair<br>value | Interest<br>rate | Carrying<br>value | Fair<br>value | Interest<br>rate |
| Notes receivable from affiliate             | \$ 70.0           | \$ 71.7       | 7.00%            | \$ 70.0           | \$ 69.9       | 7.00%            |

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**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 June 30, 2010 and December 31, 2009, consisted of the following:

(\$ millions, except interest rates)

|  | June 30, 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                   | \$ 101.5        | \$ 103.2        | 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            | 4.74          | 15.5              | 15.5            | 4.46          |
| <i>Total notes payable</i>   | <b>\$ 117.0</b> | <b>\$ 118.7</b> |               | <b>\$ 117.2</b>   | <b>\$ 117.3</b> |               |

**7. Income Taxes**

Federal income tax (benefit) expense for the three and six months ended June 30, 2010 was \$(3.8) million and \$3.9 million, respectively. Federal income tax (benefit) expense for the three and six months ended June 30, 2010 was determined using an annual effective tax rate for 2010. The Company would have had a tax benefit for the six month period but for a one-time tax charge of \$4.5 million which was recognized in the first quarter 2010 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.

For the six months ended June 30, 2009, the uncertainty of the Company's expected full year results at the time precluded the Company from making a reliable estimate of the annual effective tax rate. Accordingly, the Company recorded a tax benefit based on the actual results for the six months ended June 30, 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 \$0.2 million and \$1.6 million during the three and six months ended June 30, 2010, respectively, and anticipates additional charges of approximately \$1.1 million through the fourth quarter 2010, the expected completion date of the restructuring. The Company recognized restructuring costs totaling \$1.0 million, for both the three and six months ended June 30, 2009. These charges are included in losses and loss expenses and acquisition and operating expenses on the condensed consolidated statements of income.



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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Total cumulative estimated costs to be incurred, costs incurred during the three and six months ended June 30, 2010 and 2009, and total cumulative costs incurred through June 30, 2010 were as follows:

| (\$ millions)                 | Total cumulative estimated costs to be incurred | Three months ended June 30, |            | Six months ended June 30, |            | Cumulative costs incurred through June 30, 2010 |
|-------------------------------|---|-----------------------------|------------|---------------------------|------------|---|
|                               |   | 2010                        | 2009       | 2010                      | 2009       |   |
| Employee termination benefits | \$ 6.7  | 0.3                         | 0.7        | 1.7                       | 0.7        | 6.2   |
| Relocation costs              | 3.3   | 0.3                         | 0.3        | 0.8                       | 0.3        | 2.2   |
| Lease termination             | 0.4   | 0.1                         |            | 0.2                       |            | 0.4   |
| Benefit plan curtailment gain | (2.9)   | (0.5)                       |            | (1.1)                     |            | (2.4)   |
| <b>Total</b>                  | <b>\$ 7.5</b>                                   | <b>0.2</b>                  | <b>1.0</b> | <b>1.6</b>                | <b>1.0</b> | <b>6.4</b>                                      |

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

| (\$ millions)      | Total cumulative estimated costs to be incurred | Three months ended June 30, |            | Six months ended June 30, |            | Cumulative costs incurred through June 30, 2010 |
|--------------------|---|-----------------------------|------------|---------------------------|------------|---|
|                    |   | 2010                        | 2009       | 2010                      | 2009       |   |
| Personal insurance | \$ 3.8  | 0.1                         | 0.6        | 0.9                       | 0.6        | 3.4   |
| Business insurance | 3.7   | 0.1                         | 0.4        | 0.7                       | 0.4        | 3.0   |
| <b>Total</b>       | <b>\$ 7.5</b>                                   | <b>0.2</b>                  | <b>1.0</b> | <b>1.6</b>                | <b>1.0</b> | <b>6.4</b>                                      |

Activity for the six months ended June 30, 2010 was as follows:

| (\$ millions)                                 | Balance of liability at January 1, 2010 | Costs incurred during the six months ended June 30, 2010 | Amounts paid during the six months ended June 30, 2010 | Balance of liability at June 30, 2010 |
|---|---|--|--|---------------------------------------|
|   | Employee termination benefits           | \$ 3.9   | 1.7  | 2.0                                   |
| Relocation costs                              |   | 0.8  | 0.8  |                                       |
| Lease termination                             | 0.1                                     | 0.2  | 0.1  | 0.2                                   |
| Benefit plan curtailment gain (non-cash item) |   | (1.1)  |  |                                       |

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|              |        |     |     |     |
|--------------|--------|-----|-----|-----|
| <i>Total</i> | \$ 4.0 | 1.6 | 2.9 | 3.8 |
|--------------|--------|-----|-----|-----|



## 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 |       | Pension                  |       | Postretirement |       |
|--------------------------------|----------------------------|-------|----------------|-------|--------------------------|-------|----------------|-------|
|                                | Three months ended June 30 |       |                |       | Six months ended June 30 |       |                |       |
|                                | 2010                       | 2009  | 2010           | 2009  | 2010                     | 2009  | 2010           | 2009  |
| Service cost                   | \$ 2.7                     | 3.2   | \$ 1.2         | 1.3   | \$ 5.3                   | 5.5   | \$ 2.3         | 2.7   |
| Interest cost                  | 3.7                        | 4.2   | 1.4            | 1.8   | 7.4                      | 7.3   | 2.8            | 3.6   |
| Expected return on plan assets | (4.4)                      | (5.4) |                | (0.1) | (8.8)                    | (9.9) | (0.1)          | (0.1) |
| Curtailment loss (gain)        |                            |       | (0.6)          |       |                          |       | (1.1)          |       |
| Amortization of:               |                            |       |                |       |                          |       |                |       |
| Prior service costs (benefits) | 0.1                        | 0.1   | (0.4)          |       | 0.2                      | 0.2   | (0.8)          | 0.1   |
| Transition assets              | (0.2)                      | (0.1) |                |       | (0.4)                    | (0.3) |                |       |
| Net loss                       | 1.6                        | 1.6   |                |       | 3.0                      | 2.6   |                | 0.2   |
| <i>Net periodic cost</i>       | <b>\$ 3.5</b>              | 3.6   | <b>\$ 1.6</b>  | 3.0   | <b>\$ 6.7</b>            | 5.4   | <b>\$ 3.1</b>  | 6.5   |

For the six months ended June 30, 2010, the Company has contributed \$4.0 million in cash to its pension plan, and expects to contribute up to \$15.0 million during 2010.

In November 2009, the Company announced to its employees a one-time election to select between two retirement benefit options: to either continue participation in the existing pension plan with no changes; or to choose a new defined contribution plan in which the Company would automatically contribute a percentage of the employee's annual income resulting in a freeze to the employee's existing accrued pension benefit. On May 31, 2010, employees' elections were finalized and resulted in a curtailment within the pension plan, requiring the Company to remeasure its projected benefit obligations and plan assets in order to recognize the curtailment at the event date. The combined balance sheet financial statement impact from the remeasurement and curtailment recognition at May 31, 2010 was an increase to the net unfunded pension liability of \$21.1 million and accumulated other comprehensive loss of \$13.7 million, net of tax.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**10. Loss per Common Share**

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

| <i>(\$ millions, except per share amounts)</i> | Three months ended<br>June 30 |        | Six months ended<br>June 30 |        |
|--|-------------------------------|--------|-----------------------------|--------|
|  | 2010                          | 2009   | 2010                        | 2009   |
| <b>Numerator:</b>                              |                               |        |                             |        |
| Net loss for basic loss per share              | \$ (26.2)                     | (3.2)  | \$ (13.3)                   | (17.2) |
| <b>Denominator:</b>                            |                               |        |                             |        |
| Basic weighted average shares outstanding      | 39.9                          | 39.6   | 39.9                        | 39.6   |
| Effect of dilutive share-based awards          |                               |        |                             |        |
| Diluted weighted average shares outstanding    | 39.9                          | 39.6   | 39.9                        | 39.6   |
| Basic loss per share                           | \$ (0.66)                     | (0.08) | \$ (0.33)                   | (0.44) |
| Diluted loss per share                         | \$ (0.66)                     | (0.08) | \$ (0.33)                   | (0.44) |

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:

| <i>(number of options in millions)</i> | Three months ended<br>June 30 |      | Six months ended<br>June 30 |      |
|--|-------------------------------|------|-----------------------------|------|
|  | 2010                          | 2009 | 2010                        | 2009 |
| Number of options                      | 2.6                           | 2.4  | 2.4                         | 2.1  |

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 (Loss) Income**

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

| (\$ millions)   | Three months ended |       | Six months ended |        |
|---|--------------------|-------|------------------|--------|
|   | June 30            |       | June 30          |        |
|   | 2010               | 2009  | 2010             | 2009   |
| Net loss  | \$ (26.2)          | (3.2) | \$ (13.3)        | (17.2) |
| Other comprehensive (loss) income:                          |                    |       |                  |        |
| Change in unrealized holding gains (losses), net of tax     | (5.7)              | 13.5  | (0.3)            | 31.1   |
| Amortization of gain on derivative used in cash flow hedge  | (0.1)              |       | (0.1)            |        |
| Change in unrecognized benefit plan obligations, net of tax | (13.3)             | 12.6  | (13.0)           | 13.2   |
| <i>Total other comprehensive (loss) income</i>              | <b>(19.1)</b>      | 26.1  | <b>(13.4)</b>    | 44.3   |
| <i>Comprehensive (loss) income</i>                          | <b>\$ (45.3)</b>   | 22.9  | <b>\$ (26.7)</b> | 27.1   |

**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.

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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 provides financial information regarding the Company's reportable segments:

| (\$ millions)  | Three months ended |        | Six months ended |        |
|--|--------------------|--------|------------------|--------|
|  | 2010               | 2009   | 2010             | 2009   |
| Revenues from external sources:                        |                    |        |                  |        |
| Insurance segments                                     |                    |        |                  |        |
| Personal insurance                                     | \$ 199.1           | 180.5  | \$ 393.0         | 354.3  |
| Business insurance                                     | 110.2              | 112.1  | 218.9            | 224.3  |
| <i>Total insurance segments</i>                        | <b>309.3</b>       | 292.6  | <b>611.9</b>     | 578.6  |
| Investment operations segment                          |                    |        |                  |        |
| Net investment income                                  | 20.8               | 20.8   | 41.3             | 39.1   |
| Net realized capital gains (losses)                    | 0.3                | 2.5    | 3.5              | (8.8)  |
| <i>Total investment operations segment</i>             | <b>21.1</b>        | 23.3   | <b>44.8</b>      | 30.3   |
| All other  | 0.7                | 1.0    | 1.1              | 2.0    |
| <i>Total revenues from external sources</i>            | <b>331.1</b>       | 316.9  | <b>657.8</b>     | 610.9  |
| Intersegment revenues:                                 | 2.4                | 2.3    | 4.8              | 4.9    |
| <i>Total revenues</i>                                  | <b>333.5</b>       | 319.2  | <b>662.6</b>     | 615.8  |
| Reconciling items:                                     |                    |        |                  |        |
| GAAP premium adjustment                                |                    |        | (0.3)            |        |
| Eliminate intersegment revenues                        | (2.4)              | (2.3)  | (4.8)            | (4.9)  |
| <i>Total consolidated revenues</i>                     | <b>\$ 331.1</b>    | 316.9  | <b>\$ 657.5</b>  | 610.9  |
| Segment loss before federal income tax:                |                    |        |                  |        |
| Insurance segments                                     |                    |        |                  |        |
| Personal insurance SAP underwriting loss               | \$ (28.5)          | (26.1) | \$ (22.8)        | (53.2) |
| Business insurance SAP underwriting loss               | (25.5)             | (11.7) | (27.5)           | (15.1) |
| <i>Total insurance segments</i>                        | <b>(54.0)</b>      | (37.8) | <b>(50.3)</b>    | (68.3) |
| Investment operations segment                          |                    |        |                  |        |
| Net investment income                                  | 20.8               | 20.8   | 41.3             | 39.1   |
| Net realized capital gains (losses)                    | 0.3                | 2.5    | 3.5              | (8.8)  |
| <i>Total investment operations segment</i>             | <b>21.1</b>        | 23.3   | <b>44.8</b>      | 30.3   |
| All other segments                                     |                    | (0.1)  |                  | (0.6)  |
| <i>Total segment loss before tax (benefit) expense</i> | <b>(32.9)</b>      | (14.6) | <b>(5.5)</b>     | (38.6) |

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|  |                  |        |                 |        |
|--|------------------|--------|-----------------|--------|
| <b>Reconciling items:</b>  |                  |        |                 |        |
| GAAP expense adjustments   | <b>5.6</b>       | 5.5    | <b>0.8</b>      | 0.6    |
| Interest expense on corporate debt   | <b>(1.8)</b>     | (1.8)  | <b>(3.6)</b>    | (3.8)  |
| Corporate expenses   | <b>(0.9)</b>     | (0.8)  | <b>(1.1)</b>    | (0.8)  |
| <i>Total reconciling items</i>   | <b>2.9</b>       | 2.9    | <b>(3.9)</b>    | (4.0)  |
| <i>Total consolidated loss before federal income tax (benefit) expense</i> | <b>\$ (30.0)</b> | (11.7) | <b>\$ (9.4)</b> | (42.6) |

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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)

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

| (\$ millions)                                   | Three months ended |       | Six months ended |       |
|---|--------------------|-------|------------------|-------|
|   | June 30<br>2010    | 2009  | June 30<br>2010  | 2009  |
| <b>Earned premiums:</b>                         |                    |       |                  |       |
| Personal insurance:                             |                    |       |                  |       |
| Standard auto                                   | \$ 119.9           | 106.4 | \$ 236.5         | 207.9 |
| Nonstandard auto                                | 7.4                | 10.1  | 14.7             | 20.1  |
| Homeowners                                      | 63.6               | 56.4  | 125.5            | 111.2 |
| Other personal                                  | 8.2                | 7.6   | 16.3             | 15.1  |
| <i>Total personal insurance earned premiums</i> | <b>199.1</b>       | 180.5 | <b>393.0</b>     | 354.3 |
| Business insurance:                             |                    |       |                  |       |
| Commercial auto                                 | 25.7               | 26.9  | 50.7             | 54.1  |
| Commercial multi-peril                          | 26.2               | 24.0  | 50.5             | 48.0  |
| Fire & allied lines                             | 24.6               | 24.2  | 49.4             | 48.0  |
| Other & product liability                       | 17.4               | 19.1  | 35.2             | 38.5  |
| Workers compensation                            | 10.3               | 11.4  | 20.7             | 22.3  |
| Other commercial                                | 6.0                | 6.5   | 12.4             | 13.4  |
| <i>Total business insurance earned premiums</i> | <b>110.2</b>       | 112.1 | <b>218.9</b>     | 224.3 |
| <i>Total SAP earned premiums</i>                | <b>309.3</b>       | 292.6 | <b>611.9</b>     | 578.6 |
| GAAP premium adjustment                         |                    |       | (0.3)            |       |
| <i>Total GAAP earned premiums</i>               | <b>309.3</b>       | 292.6 | <b>611.6</b>     | 578.6 |
| Investment operations:                          |                    |       |                  |       |
| Net investment income                           | 20.8               | 20.8  | 41.3             | 39.1  |
| Net realized capital gain (loss)                | 0.3                | 2.5   | 3.5              | (8.8) |
| <i>Total investment operations</i>              | <b>21.1</b>        | 23.3  | <b>44.8</b>      | 30.3  |
| <i>Total revenues from reportable segments</i>  | <b>\$ 330.4</b>    | 315.9 | <b>\$ 656.4</b>  | 608.9 |

Investable assets attributable to our investment operations segment totaled \$2,305.7 million at June 30, 2010, and \$2,269.4 million at December 31, 2009.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**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.

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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 "second quarter" as used below refers to the three months ended June 30 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 June 30, 2010 and December 31, 2009, and for the consolidated statements of income for the three-month and six-month periods ended June 30, 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 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 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."





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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:

|                                   |               |
|-----------------------------------|---------------|
| <i>(\$ millions)</i>              |               |
| 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)         |
| <i>Net cash received</i>          | <b>\$ 3.7</b> |

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

|  | January 1, 2009<br>December 31, 2009 | <b>January 1, 2010<br/>June 30, 2010</b> |
|--|--------------------------------------|--|
| <b>STFC Pooled Companies:</b>              |                                      |  |
| State Auto P&C                             | 59.0%                                | <b>59.0%</b>                             |
| Milbank                                    | 17.0                                 | <b>17.0</b>                              |
| Farmers                                    | 3.0                                  | <b>3.0</b>                               |
| SA Ohio                                    | 1.0                                  | <b>1.0</b>                               |
| SA National                                | N/A                                  | <b>0.0</b>                               |
| <i>Total</i>                               | 80.0                                 | <b>80.0</b>                              |
| <b>State Auto Mutual Pooled Companies:</b> |                                      |  |
| State Auto Mutual                          | 19.0                                 | <b>19.0</b>                              |
| SA Wisconsin                               | 0.0                                  | <b>0.0</b>                               |
| SA Florida                                 | 0.0                                  | <b>0.0</b>                               |
| Meridian Security                          | 0.0                                  | <b>0.0</b>                               |
| Meridian Citizens Mutual                   | 0.5                                  | <b>0.5</b>                               |
| Beacon National                            | 0.0                                  | <b>0.0</b>                               |
| Patrons Mutual                             | 0.4                                  | <b>0.4</b>                               |
| Litchfield                                 | 0.1                                  | <b>0.1</b>                               |
| <i>Total</i>                               | 20.0                                 | <b>20.0</b>                              |

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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**RESULTS OF OPERATIONS**

During the second quarter 2010, we recognized a net loss of \$26.2 million compared to a net loss of \$3.2 million for the same 2009 period. The second quarter 2010 pretax loss was \$30.0 million compared to a pretax loss of \$11.7 million for the same 2009 period. Our second quarter 2010 insurance segments results were negatively impacted by the frequency and severity of catastrophe losses, as we experienced 13 catastrophes in the second quarter 2010 compared to 11 during the same 2009 period, with 60% of these catastrophes occurring in four of our largest property states: Indiana, Minnesota, Ohio and Tennessee. These catastrophe losses were slightly offset by an increase in earned premium due to growth in our personal lines. A decrease in the level of realized investment gains in our investment segment also impacted our results for the second quarter 2010.

During the six months ended June 30, 2010, we recognized a net loss of \$13.3 million compared to a net loss of \$17.2 million for the same 2009 period. The pretax loss was \$9.4 million for the six months ended June 30, 2010, compared to a pretax loss of \$42.6 million for the same 2009 period. The decrease in our level of pre-tax net loss for the first six months of 2010 from 2009 was primarily attributable to an increase in earned premium due to growth in our personal lines, a decline in the level of catastrophe losses in our insurance segments, and an increase in the level of net investment income and realized investment gains in our investment segment.



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### Insurance Segments

Insurance industry regulators require our insurance subsidiaries to report their financial condition and results of operations using SAP. We use SAP financial results, along with industry standard financial measures determined on a SAP basis and certain measures determined on a GAAP basis, to internally monitor the performance of our insurance segments. The more common financial measures used are Loss and LAE ratio, underwriting expense ratio, combined ratio, net premiums written and net premiums earned. The combined ratio is the sum of the Loss and LAE ratio and the underwriting expense ratio. When the combined ratio is less than 100%, the insurer is operating at an underwriting gain and when it is greater than 100%, the insurer is operating at an underwriting loss. Underwriting gain (loss) is determined by subtracting from net earned premiums, losses and loss expenses and underwriting expenses.

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred policy acquisition costs, see Critical Accounting Policies Deferred Acquisition Costs included in Item 7 of our 2009 Form 10-K. The GAAP combined ratio is defined as the sum of the GAAP Loss and LAE ratio (loss and loss expenses as a percentage of earned premiums) plus GAAP expense ratio (acquisition and operating expenses as a percentage of earned premiums).

Charges related to the restructuring of our field and claims operations also contributed to the difference between GAAP and SAP. The restructuring differences relate mainly to the timing of the recognition of employee termination benefits. SAP requires us to estimate and immediately recognize the entire estimated costs related to severance, while GAAP requires similar estimated costs to be recognized ratably over the remaining service period of the employees impacted.

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All references to financial measures or components thereof in this discussion are calculated on a GAAP basis, unless otherwise noted. The following tables provide a summary of our insurance segments' SAP underwriting gain (loss) and SAP combined ratio for the three and six months ended June 30, 2010 and 2009:

(\$ millions)

|  | Three months ended<br>June 30, 2010 |            |           |            |           |            |
|--|-------------------------------------|------------|-----------|------------|-----------|------------|
|  | Personal                            | %<br>Ratio | Business  | %<br>Ratio | Total     | %<br>Ratio |
| Net written premiums                         | \$ 218.2                            |            | \$ 133.9  |            | \$ 352.1  |            |
| Net earned premiums                          | 199.1                               |            | 110.2     |            | 309.3     |            |
| Losses and loss expenses                     | 165.4                               | 83.1       | 85.3      | 77.3       | 250.7     | 81.0       |
| Underwriting expenses                        | 62.2                                | 28.5       | 50.4      | 37.7       | 112.6     | 32.0       |
| SAP underwriting loss and SAP combined ratio | \$ (28.5)                           | 111.6      | \$ (25.5) | 115.0      | \$ (54.0) | 113.0      |

(\$ millions)

|  | Three months ended<br>June 30, 2009 |            |           |            |           |            |
|--|-------------------------------------|------------|-----------|------------|-----------|------------|
|  | Personal                            | %<br>Ratio | Business  | %<br>Ratio | Total     | %<br>Ratio |
| Net written premiums                         | \$ 202.9                            |            | \$ 115.1  |            | \$ 318.0  |            |
| Net earned premiums                          | 180.5                               |            | 112.1     |            | 292.6     |            |
| Losses and loss expenses                     | 145.9                               | 80.8       | 80.1      | 71.5       | 226.0     | 77.2       |
| Underwriting expenses                        | 60.7                                | 29.9       | 43.7      | 38.0       | 104.4     | 32.8       |
| SAP underwriting loss and SAP combined ratio | \$ (26.1)                           | 110.7      | \$ (11.7) | 109.5      | \$ (37.8) | 110.0      |

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(\$ millions)

|  | Six months ended<br>June 30, 2010 |            |           |            |           |            |
|--|-----------------------------------|------------|-----------|------------|-----------|------------|
|  | Personal                          | %<br>Ratio | Business  | %<br>Ratio | Total     | %<br>Ratio |
| Net written premiums <sup>(1)</sup>          | \$ 408.2                          |            | \$ 246.4  |            | \$ 654.6  |            |
| Net earned premiums                          | 393.0                             |            | 218.9     |            | 611.9     |            |
| Losses and loss expenses                     | 297.7                             | 75.8       | 151.3     | 69.1       | 449.0     | 73.4       |
| Underwriting expenses                        | 118.1                             | 28.9       | 95.1      | 38.6       | 213.2     | 32.6       |
| SAP underwriting loss and SAP combined ratio | \$ (22.8)                         | 104.7      | \$ (27.5) | 107.7      | \$ (50.3) | 106.0      |

(\$ millions)

|  | Six months ended<br>June 30, 2009 |            |           |            |           |            |
|--|-----------------------------------|------------|-----------|------------|-----------|------------|
|  | Personal                          | %<br>Ratio | Business  | %<br>Ratio | Total     | %<br>Ratio |
| Net written premiums                         | \$ 376.9                          |            | \$ 228.2  |            | \$ 605.1  |            |
| Net earned premiums                          | 354.3                             |            | 224.3     |            | 578.6     |            |
| Losses and loss expenses                     | 295.6                             | 83.4       | 153.7     | 68.5       | 449.3     | 77.7       |
| Underwriting expenses                        | 111.9                             | 29.7       | 85.7      | 37.6       | 197.6     | 32.7       |
| SAP underwriting loss and SAP combined ratio | \$ (53.2)                         | 113.1      | \$ (15.1) | 106.1      | \$ (68.3) | 110.4      |

<sup>(1)</sup> Includes the one-time transfer of \$1.4 million of unearned premiums to the Mutual Pooled Companies on January 1, 2010, in conjunction with the 2010 pooling changes (transfer of \$2.1 million of our personal insurance segment and receipt of \$0.7 million of the Mutual Pooled Companies' business insurance segment).

Revenue

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

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The following table shows the reconciliation of the one-time impact on net written premiums for the six months ended June 30, 2010, of the unearned premiums transferred to the Mutual Pooled Companies on January 1, 2010, in conjunction with the 2010 pooling changes.

| (\$ millions)                             | Net Written Premiums<br>Reconciliation Table |                             |                                |
|---|--|-----------------------------|--------------------------------|
|   | Including<br>pooling<br>change               | Pooling<br>change<br>impact | Excluding<br>pooling<br>change |
| <b><u>Personal insurance segment:</u></b> |  |                             |                                |
| Standard auto                             | \$ 246.9                                     |                             | 246.9                          |
| Nonstandard auto                          | 13.2   | (2.1)                       | 15.3                           |
| Homeowners                                | 130.9  |                             | 130.9                          |
| Other personal                            | 17.2   |                             | 17.2                           |
| <i>Total personal</i>                     | 408.2  | (2.1)                       | 410.3                          |
| <b><u>Business insurance segment:</u></b> |  |                             |                                |
| Commercial auto                           | 62.6   |                             | 62.6                           |
| Commercial multi-peril                    | 64.1   | 0.7                         | 63.4                           |
| Fire & allied lines                       | 49.0   |                             | 49.0                           |
| Other & product liability                 | 36.2   |                             | 36.2                           |
| Workers compensation                      | 21.2   |                             | 21.2                           |
| Other business                            | 13.3   |                             | 13.3                           |
| <i>Total business</i>                     | 246.4  | 0.7                         | 245.7                          |
| <i>Total net written premiums</i>         | \$ 654.6                                     | (1.4)                       | 656.0                          |

*Personal Insurance Segment Revenue*

Our personal insurance segment consists primarily of auto (standard and nonstandard) and homeowners products, with personal auto representing 40.0% of our total consolidated net written premiums for the six months ended June 30, 2010. Our strategy is to grow our personal lines business in desired geographic locations by introducing new products, enhanced systems and easier-to-use technologies.

During 2010, we continue to enhance our personal lines point of sale portal, netXpress<sup>SM</sup>, by introducing new rating technologies. In addition to netXpress, our agents are able to quote our products through the use of comparative rating tools. With over 200 different integration points, the State Auto Group received over 845,000 personal lines quotes through comparative raters, bridging solutions and netXpress during the six months ended June 30, 2010, an increase of over 25% compared to the same 2009 period.

CustomFit<sup>SM</sup>, our standard auto product, provides additional quoting opportunities by allowing our agents to tailor policies to fit the insured's needs. Further expanding our product portfolio, in the fourth quarter of 2009 we introduced our new homeowners CustomFit product which uses predictive modeling and by-peril rating.





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The following tables provide a summary of written and earned premiums, net of reinsurance, by major product line of business for our personal insurance segment for the three and six months ended June 30, 2010 and 2009. The one-time impact of the 2010 pooling changes has been excluded from 2010 to present net written premiums on a comparative basis (see Net Written Premium Reconciliation Table above):

| (\$ millions)                      | Three months ended<br>June 30 |       |             | Six months ended<br>June 30 |       |             |
|------------------------------------|-------------------------------|-------|-------------|-----------------------------|-------|-------------|
|                                    | Net Written Premiums          |       |             |                             |       |             |
|                                    | 2010                          | 2009  | %<br>Change | 2010                        | 2009  | %<br>Change |
| <u>Personal insurance segment:</u> |                               |       |             |                             |       |             |
| Standard auto                      | \$ 127.1                      | 117.6 | 8.1         | \$ 246.9                    | 224.4 | 10.0        |
| Nonstandard auto                   | 6.7                           | 9.2   | (27.2)      | 15.3                        | 20.4  | (25.0)      |
| Homeowners                         | 75.3                          | 67.8  | 11.1        | 130.9                       | 116.3 | 12.6        |
| Other personal                     | 9.1                           | 8.3   | 9.6         | 17.2                        | 15.8  | 8.9         |
| <i>Total personal</i>              | \$ 218.2                      | 202.9 | 7.5         | \$ 410.3                    | 376.9 | 8.9         |
|                                    |                               |       |             |                             |       |             |
|                                    | Net Earned Premiums           |       |             |                             |       |             |
|                                    | 2010                          | 2009  | %<br>Change | 2010                        | 2009  | %<br>Change |
| <u>Personal insurance segment:</u> |                               |       |             |                             |       |             |
| Standard auto                      | \$ 119.9                      | 106.4 | 12.7        | \$ 236.5                    | 207.9 | 13.8        |
| Nonstandard auto                   | 7.4                           | 10.1  | (26.7)      | 14.7                        | 20.1  | (26.9)      |
| Homeowners                         | 63.6                          | 56.4  | 12.8        | 125.2                       | 111.2 | 12.6        |
| Other personal                     | 8.2                           | 7.6   | 7.9         | 16.3                        | 15.1  | 7.9         |
| <i>Total personal</i>              | \$ 199.1                      | 180.5 | 10.3        | \$ 392.7                    | 354.3 | 10.8        |

Standard personal auto net written premiums for the three and six months ended June 30, 2010 increased 8.1% and 10.0%, respectively, compared to the same 2009 periods. The State Auto Group's expansion of its operations within four of our newer states, Texas, Colorado, Arizona and Connecticut, contributed to approximately half of this premium growth in standard personal auto, with recent rate increases accounting for the remainder of the growth. Our auto product, CustomFit, coupled with easier quote capabilities, continues to result in a significant increase in new business quotes. While the number of new business quotes is higher, our issue to quote ratio has begun to decline due to our rate activity.

Nonstandard auto net written premium for the three and six months ended June 30, 2010 decreased 27.2% and 25.0%, respectively, compared to the same 2009 periods. A significant portion of this decline was due to the addition of nonstandard auto business written by SA National to the Pooling Arrangement effective January 1, 2010 (20% of this business is ceded to the Mutual Pooled Companies). Also contributing to this decline was certain underwriting actions taken in 2009 that include increasing rates and terminating certain agencies that failed to consistently perform to our expectations. These actions, coupled with the impact of general economic conditions, continue to result in a reduction of nonstandard auto business.



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Homeowners net written premiums for the three and six months ended June 30, 2010 increased 11.1% and 12.6%, respectively, compared to the same 2009 periods. Rate increases accounted for two-thirds of this premium growth and expansion of our business in Texas, Colorado, Arizona and Connecticut accounted for the remainder of the growth. We continue to aggressively address our rate needs in this line of business, seeking higher rates in 2010. In addition, we intend to continue a state-by-state deployment of our homeowners CustomFit product throughout 2010 and 2011.

*Business Insurance Segment Revenue*

Our business insurance accounts are primarily small to medium sized exposures where we offer a broad range of both property and liability coverages. Larger exposure accounts are handled in our middle market unit. Property and casualty coverages in the alternative risk transfer and program markets are written through our underwriting management agreement with Risk Evaluation and Design, LLC ( RED ). The following table provides a summary of written and earned premiums, net of reinsurance, by major product line for our business insurance segment for the three and six months ended June 30, 2010 and 2009. The one-time impact of the 2010 pooling changes has been excluded from 2010 to present net written premiums on a comparative basis (see Net Written Premium Reconciliation Table above):

| (\$ millions)                      | Three months ended<br>June 30 |       |             | Six months ended<br>June 30 |       |             |
|------------------------------------|-------------------------------|-------|-------------|-----------------------------|-------|-------------|
|                                    | 2010                          | 2009  | %<br>Change | 2010                        | 2009  | %<br>Change |
|                                    | Net Written Premiums          |       |             |                             |       |             |
| <u>Business insurance segment:</u> |                               |       |             |                             |       |             |
| Commercial auto                    | \$ 38.1                       | 27.2  | 40.1        | \$ 62.6                     | 53.2  | 17.7        |
| Commercial multi-peril             | 33.9                          | 24.9  | 36.1        | 63.4                        | 49.1  | 29.1        |
| Fire & allied lines                | 25.0                          | 24.9  | 0.4         | 49.0                        | 49.4  | (0.8)       |
| Other & product liability          | 19.0                          | 19.7  | (3.6)       | 36.2                        | 39.0  | (7.2)       |
| Workers compensation               | 11.0                          | 11.5  | (4.3)       | 21.2                        | 24.1  | (12.0)      |
| Other commercial                   | 6.9                           | 6.9   |             | 13.3                        | 13.4  | (0.7)       |
| <i>Total business</i>              | <b>\$ 133.9</b>               | 115.1 | 16.3        | <b>\$ 245.7</b>             | 228.2 | 7.7         |
|                                    | Net Earned Premiums           |       |             |                             |       |             |
|                                    |                               |       |             |                             |       |             |
| <u>Business insurance segment:</u> |                               |       |             |                             |       |             |
| Commercial auto                    | \$ 25.7                       | 26.9  | (4.5)       | \$ 50.7                     | 54.1  | (6.3)       |
| Commercial multi-peril             | 26.2                          | 24.0  | 9.2         | 50.5                        | 48.0  | 5.2         |
| Fire & allied lines                | 24.6                          | 24.2  | 1.7         | 49.4                        | 48.0  | 2.9         |
| Other & product liability          | 17.4                          | 19.1  | (8.9)       | 35.2                        | 38.5  | (8.6)       |
| Workers compensation               | 10.3                          | 11.4  | (9.6)       | 20.7                        | 22.3  | (7.2)       |
| Other commercial                   | 6.0                           | 6.5   | (7.7)       | 12.4                        | 13.4  | (7.5)       |
| <i>Total business</i>              | <b>\$ 110.2</b>               | 112.1 | (1.7)       | <b>\$ 218.9</b>             | 224.3 | (2.4)       |



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Net written premiums for the three and six months ended June 30, 2010 increased 16.3% and 7.7%, respectively, compared to the same 2009 periods. The State Auto Group's underwriting management agreement with RED accounted for approximately 16.2 points and 10.7 points, respectively, of the premium growth for the three and six months ended June 30, 2010. Business insurance continues to be impacted by rate competition and general economic conditions, as well as ease of doing business issues. After strengthening our premium per exposure on our renewal policies in the second half of 2009, our premium per exposure on policies other than RED and middle market business decreased slightly in the first half of 2010. We believe it will be difficult to generate measurable premium growth in our current book of business, other than RED, given the impact of the economy on premium bases such as payrolls, sales and number of vehicles. However, we are seeking to balance our traditional underwriting discipline with new products and pricing tools that support the production of profitable new business.

RED, a subsidiary of State Auto Mutual, acts as a managing general underwriter for a variety of property and casualty coverages in the alternative risk transfer and program markets. Through an underwriting management agreement with RED, the State Auto Group writes commercial business and offers insurance coverages for the alternative risk transfer market for business products such as general liability, auto liability, workers' compensation, property, inland marine, auto physical damage and miscellaneous professional. The insurance coverages written by our Pooled Companies through RED are subject to the Pooling Arrangement. Excluding the impact of the 2010 pooling changes, for the three and six months ended June 30, 2010, this amounted to \$7.9 million and \$13.6 million, respectively, of commercial multi-peril net written premium, and for commercial auto, \$10.8 million for the three and six months ended June 30, 2010. The underwriting management agreement with RED was not in place in 2009.

We continue to invest in products, processes and systems that we believe will increase our business insurance writings. We have implemented a pricing process that we believe will help us price property, liability and auto risks at appropriate levels; we are pursuing the same for our workers' compensation business. In addition, we have broadened our property, liability, auto and workers' compensation pricing ranges to improve our ability to recognize the spectrum of risks within our markets.

We continue to enhance our insurance policy administration system to make it easier for our agents to quote and submit business insurance policies to us. Our system now allows transactions to be processed throughout the day using real-time and straight-through processing rather than in large batch cycles at night. We have leveraged this functionality with bizXpress<sup>SM</sup>, our web-based quote system, to give agents the ability to quote businessowners and commercial auto risks on-line, and in the second quarter, we expanded the scope of bizXpress to add workers compensation. We believe this technology investment should better position us for revenue growth opportunities in the future and start to drive efficiencies into our business model much like we have seen in personal insurance. The majority of all transactions in business insurance utilize the straight-through processing technology. The use of this technology has resulted in faster delivery of policies to our agents and their insureds for new business and endorsements.

We have also expanded the eligibility of our businessowners product to facilitate businesses with greater liability exposures, such as artisan contractors, auto service garages, manufacturers and restaurants. While we regularly insure these types of businesses through other insurance products, offering them in our businessowners program leverages our bizXpress technology, simplifies agents' rating and submission processes, and offers broader base coverages for these types of risks. Through the second quarter 2010, we have implemented our enhanced businessowners product in 28 states.

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*Loss and LAE*

Catastrophe storm losses accounted for much of the variability in the Loss and LAE ratio when comparing the three and six months ended June 30, 2010 to the same 2009 periods. Our catastrophe losses for the three and six months ended June 30, 2010 totaled \$57.5 million (18.6 loss ratio points) and \$67.6 million (11.0 loss ratio points), respectively, compared to \$36.9 million (12.6 loss ratio points) and \$80.7 million (14.0 loss ratio points), respectively, for the same 2009 periods.

Members of the State Auto Group maintain a property catastrophe net aggregate excess of loss reinsurance agreement (the CAT Aggregate Agreement). See Reinsurance Arrangements section for a further discussion of the CAT Aggregate Agreement. Of the twenty catastrophes from which we experienced losses during the first half of 2010, six met the minimum \$5.0 million requirement; however, in aggregate we have not exceeded the State Auto Group's \$90 million retention level. Six of the seventeen catastrophes experienced during the first half of 2009 met the minimum \$5.0 million requirement and in aggregate exceeded the State Auto Group's \$80 million retention level. Our share of recoveries under the CAT Aggregate Agreement for the three and six months ended June 30, 2009 was \$7.6 million, benefitting our loss ratio by 2.6 points and 1.3 points for those periods, respectively.

The following tables provide our insurance segments' SAP Loss and LAE ratios (loss ratios) by major lines of business for the three months ended June 30, 2010 and 2009 with the catastrophe (cat) and non-catastrophe (non-cat) impact shown separately:

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| Three months ended June 30, 2010       | (\$ millions)   |                |                    |                      |             | %             |             | Total Loss and LAE Ratio |
|--|-----------------|----------------|--------------------|----------------------|-------------|---------------|-------------|--------------------------|
|  | Earned Premium  | Cat Loss & LAE | Non-Cat Loss & LAE | Statutory Loss & LAE | Cat Ratio   | Non-Cat Ratio |             |                          |
| <u>Statutory Loss and LAE Ratios</u>   |                 |                |                    |                      |             |               |             |                          |
| <u>Personal insurance segment:</u>     |                 |                |                    |                      |             |               |             |                          |
| Standard auto                          | \$ 119.9        | \$ 4.6         | \$ 73.8            | \$ 78.4              | 3.8         | 61.6          | 65.4        |                          |
| Nonstandard auto                       | 7.4             | 0.2            | 4.0                | 4.2                  | 2.7         | 54.4          | 57.1        |                          |
| Homeowners                             | 63.6            | 36.6           | 39.1               | 75.7                 | 57.5        | 61.6          | 119.1       |                          |
| Other personal                         | 8.2             | 3.0            | 4.1                | 7.1                  | 37.1        | 48.1          | 85.2        |                          |
| <i>Total personal</i>                  | <b>199.1</b>    | <b>44.4</b>    | <b>121.0</b>       | <b>165.4</b>         | <b>22.3</b> | <b>60.8</b>   | <b>83.1</b> |                          |
| <u>Business insurance segment:</u>     |                 |                |                    |                      |             |               |             |                          |
| Commercial auto                        | 25.7            | 1.3            | 14.3               | 15.6                 | 5.0         | 55.6          | 60.6        |                          |
| Commercial multi-peril                 | 26.2            | 5.0            | 16.5               | 21.5                 | 19.1        | 63.2          | 82.3        |                          |
| Fire & allied lines                    | 24.6            | 6.3            | 10.9               | 17.2                 | 25.8        | 44.2          | 70.0        |                          |
| Other & product liability              | 17.4            |                | 20.3               | 20.3                 |             | 116.7         | 116.7       |                          |
| Workers compensation                   | 10.3            |                | 8.6                | 8.6                  |             | 83.8          | 83.8        |                          |
| Other commercial                       | 6.0             | 0.5            | 1.6                | 2.1                  | 7.4         | 26.5          | 33.9        |                          |
| <i>Total business</i>                  | <b>110.2</b>    | <b>13.1</b>    | <b>72.2</b>        | <b>85.3</b>          | <b>11.8</b> | <b>65.5</b>   | <b>77.3</b> |                          |
| <i>Total SAP personal and business</i> | <b>\$ 309.3</b> | <b>\$ 57.5</b> | <b>\$ 193.2</b>    | <b>\$ 250.7</b>      | <b>18.6</b> | <b>62.4</b>   | <b>81.0</b> |                          |

| Three months ended June 30, 2009     | (\$ millions)  |                |                    |                      |             | %             |             | Total Loss and LAE Ratio |
|--------------------------------------|----------------|----------------|--------------------|----------------------|-------------|---------------|-------------|--------------------------|
|                                      | Earned Premium | Cat Loss & LAE | Non-Cat Loss & LAE | Statutory Loss & LAE | Cat Ratio   | Non-Cat Ratio |             |                          |
| <u>Statutory Loss and LAE Ratios</u> |                |                |                    |                      |             |               |             |                          |
| <u>Personal insurance segment:</u>   |                |                |                    |                      |             |               |             |                          |
| Standard auto                        | \$ 106.4       | \$ 2.6         | \$ 71.8            | \$ 74.4              | 2.5         | 67.4          | 69.9        |                          |
| Nonstandard auto                     | 10.1           | 0.2            | 7.8                | 8.0                  | 1.5         | 78.0          | 79.5        |                          |
| Homeowners                           | 56.4           | 22.7           | 36.9               | 59.6                 | 40.2        | 65.4          | 105.6       |                          |
| Other personal                       | 7.6            | 1.2            | 2.7                | 3.9                  | 15.8        | 35.1          | 50.9        |                          |
| <i>Total personal</i>                | <b>180.5</b>   | <b>26.7</b>    | <b>119.2</b>       | <b>145.9</b>         | <b>14.8</b> | <b>66.0</b>   | <b>80.8</b> |                          |
| <u>Business insurance segment:</u>   |                |                |                    |                      |             |               |             |                          |
| Commercial auto                      | 26.9           | 0.3            | 13.9               | 14.2                 | 1.1         | 51.6          | 52.7        |                          |
| Commercial multi-peril               | 24.0           | 2.7            | 13.6               | 16.3                 | 11.4        | 56.6          | 68.0        |                          |
| Fire & allied lines                  | 24.2           | 6.8            | 17.1               | 23.9                 | 28.2        | 70.6          | 98.8        |                          |
| Other & product liability            | 19.1           |                | 13.9               | 13.9                 |             | 72.7          | 72.7        |                          |
| Workers compensation                 | 11.4           |                | 8.8                | 8.8                  |             | 77.7          | 77.7        |                          |
| Other commercial                     | 6.5            | 0.4            | 2.6                | 3.0                  | 5.0         | 41.7          | 46.7        |                          |
| <i>Total business</i>                | <b>112.1</b>   | <b>10.2</b>    | <b>69.9</b>        | <b>80.1</b>          | <b>9.1</b>  | <b>62.4</b>   | <b>71.5</b> |                          |



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|  |          |         |          |          |      |      |      |
|--|----------|---------|----------|----------|------|------|------|
| <i>Total SAP personal and business</i> | \$ 292.6 | \$ 36.9 | \$ 189.1 | \$ 226.0 | 12.6 | 64.7 | 77.3 |
|--|----------|---------|----------|----------|------|------|------|

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| Six months ended June 30, 2010         | (\$ millions)   |                |                    |                      |             | %             |             | Total Loss and LAE Ratio |
|--|-----------------|----------------|--------------------|----------------------|-------------|---------------|-------------|--------------------------|
|  | Earned Premium  | Cat Loss & LAE | Non-Cat Loss & LAE | Statutory Loss & LAE | Cat Ratio   | Non-Cat Ratio |             |                          |
| <u>Statutory Loss and LAE Ratios</u>   |                 |                |                    |                      |             |               |             |                          |
| <u>Personal insurance segment:</u>     |                 |                |                    |                      |             |               |             |                          |
| Standard auto                          | \$ 236.5        | \$ 5.1         | \$ 147.9           | \$ 153.0             | 2.1         | 62.6          | 64.7        |                          |
| Nonstandard auto                       | 14.7            | 0.2            | 8.8                | 9.0                  | 1.5         | 60.2          | 61.7        |                          |
| Homeowners                             | 125.5           | 41.7           | 83.6               | 125.3                | 33.2        | 66.6          | 99.8        |                          |
| Other personal                         | 16.3            | 3.1            | 7.3                | 10.4                 | 19.2        | 44.4          | 63.6        |                          |
| <i>Total personal</i>                  | <b>393.0</b>    | <b>50.1</b>    | <b>247.6</b>       | <b>297.7</b>         | <b>12.8</b> | <b>63.0</b>   | <b>75.8</b> |                          |
| <u>Business insurance segment:</u>     |                 |                |                    |                      |             |               |             |                          |
| Commercial auto                        | 50.7            | 1.4            | 25.5               | 27.0                 | 2.8         | 50.5          | 53.3        |                          |
| Commercial multi-peril                 | 50.5            | 5.9            | 30.0               | 35.9                 | 11.6        | 59.6          | 71.2        |                          |
| Fire & allied lines                    | 49.4            | 9.7            | 27.0               | 36.6                 | 19.6        | 54.5          | 74.1        |                          |
| Other & product liability              | 35.2            |                | 32.1               | 32.1                 |             | 91.2          | 91.2        |                          |
| Workers compensation                   | 20.7            |                | 16.4               | 16.4                 |             | 79.3          | 79.3        |                          |
| Other commercial                       | 12.4            | 0.5            | 2.8                | 3.3                  | 3.7         | 21.9          | 25.6        |                          |
| <i>Total business</i>                  | <b>218.9</b>    | <b>17.5</b>    | <b>133.8</b>       | <b>151.3</b>         | <b>8.0</b>  | <b>61.1</b>   | <b>69.1</b> |                          |
| <i>Total SAP personal and business</i> | <b>\$ 611.9</b> | <b>\$ 67.6</b> | <b>\$ 381.4</b>    | <b>\$ 449.0</b>      | <b>11.0</b> | <b>62.4</b>   | <b>73.4</b> |                          |

| Six months ended June 30, 2009       | (\$ millions)  |                |                    |                      |             | %             |             | Total Loss and LAE Ratio |
|--------------------------------------|----------------|----------------|--------------------|----------------------|-------------|---------------|-------------|--------------------------|
|                                      | Earned Premium | Cat Loss & LAE | Non-Cat Loss & LAE | Statutory Loss & LAE | Cat Ratio   | Non-Cat Ratio |             |                          |
| <u>Statutory Loss and LAE Ratios</u> |                |                |                    |                      |             |               |             |                          |
| <u>Personal insurance segment:</u>   |                |                |                    |                      |             |               |             |                          |
| Standard auto                        | \$ 207.9       | \$ 3.7         | \$ 138.0           | \$ 141.7             | 1.8         | 66.4          | 68.2        |                          |
| Nonstandard auto                     | 20.1           | 0.4            | 15.6               | 16.0                 | 1.5         | 78.0          | 79.5        |                          |
| Homeowners                           | 111.2          | 54.4           | 75.6               | 130.0                | 48.9        | 68.0          | 116.9       |                          |
| Other personal                       | 15.1           | 3.1            | 4.8                | 7.9                  | 20.4        | 32.0          | 52.4        |                          |
| <i>Total personal</i>                | <b>354.3</b>   | <b>61.6</b>    | <b>234.0</b>       | <b>295.6</b>         | <b>17.4</b> | <b>66.0</b>   | <b>83.4</b> |                          |
| <u>Business insurance segment:</u>   |                |                |                    |                      |             |               |             |                          |
| Commercial auto                      | 54.1           | 0.5            | 27.9               | 28.4                 | 0.9         | 51.5          | 52.4        |                          |
| Commercial multi-peril               | 48.0           | 5.1            | 25.3               | 30.4                 | 10.7        | 52.7          | 63.4        |                          |
| Fire & allied lines                  | 48.0           | 13.2           | 33.9               | 47.1                 | 27.5        | 70.6          | 98.1        |                          |
| Other & product liability            | 38.5           |                | 26.0               | 26.0                 |             | 67.6          | 67.6        |                          |
| Workers compensation                 | 22.3           |                | 16.3               | 16.3                 |             | 73.0          | 73.0        |                          |
| Other commercial                     | 13.4           | 0.3            | 5.2                | 5.5                  | 2.3         | 39.6          | 41.9        |                          |
| <i>Total business</i>                | <b>224.3</b>   | <b>19.1</b>    | <b>134.6</b>       | <b>153.7</b>         | <b>8.5</b>  | <b>60.1</b>   | <b>68.6</b> |                          |

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|  |          |         |          |          |      |      |      |
|--|----------|---------|----------|----------|------|------|------|
| <i>Total SAP personal and business</i> | \$ 578.6 | \$ 80.7 | \$ 368.6 | \$ 449.3 | 14.0 | 63.7 | 77.7 |
|--|----------|---------|----------|----------|------|------|------|

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

In the personal insurance segment, the overall non-cat loss ratio for the three and six months ended June 30, 2010 improved 5.2 points and 3.0 points, respectively, compared to the same 2009 periods. For the three months ended June 30, 2010 the non-cat loss ratios for standard auto and homeowners improved 5.8 points and 3.8 points, respectively, compared to the same 2009 period. The impact of rate increases contributed significantly to the improvement in each line, accounting for almost half of the standard auto improvement and nearly all of the homeowners improvement. In homeowners, we continue to file rate increases in the high single digit to low double digit range, which vary depending upon the state.

In total, the business insurance segment's non-cat loss ratio for the three and six months ended June 30, 2010 increased 3.1 points and 1.0 points, respectively, compared to the same 2009 periods. The other & product liability non-cat loss ratio for the three months ended June 30, 2010 was 44 points higher than the corresponding 2009 period, driven by an increase in large losses from prior accident years. This deterioration was somewhat offset by improvement in fire & allied lines due to a reduction in large losses. The fire & allied lines non-cat loss ratio for the three months ended June 30, 2010 is 26.4 points lower than for the corresponding 2009 period. Intense competition in the business insurance segment continues to impact our ability to implement price increases where needed.

Loss and loss expenses payable by major line of business at June 30, 2010 and December 31, 2009, respectively, are shown in the following table:

| <i>(\$ millions)</i>   | <b>June 30,<br/>2010</b> | December 31,<br>2009 | January 1,<br>2010 <sup>(1)</sup> | \$<br>Change <sup>(2)</sup> |
|--|--------------------------|----------------------|-----------------------------------|-----------------------------|
| <b><u>Personal insurance segment:</u></b>  |                          |                      |                                   |                             |
| Standard auto  | <b>\$ 218.1</b>          | 216.3                | 216.3                             | 1.8                         |
| Nonstandard auto   | <b>14.1</b>              | 20.2                 | 16.2                              | (2.1)                       |
| Homeowners   | <b>108.5</b>             | 75.7                 | 75.7                              | 32.8                        |
| Other personal   | <b>16.5</b>              | 13.4                 | 13.4                              | 3.1                         |
| <i>Total personal</i>  | <b>357.2</b>             | 325.6                | 321.6                             | 35.6                        |
| <b><u>Business insurance segment:</u></b>  |                          |                      |                                   |                             |
| Commercial auto  | <b>91.7</b>              | 93.7                 | 93.7                              | (2.0)                       |
| Commercial multi-peril   | <b>97.0</b>              | 89.3                 | 89.3                              | 7.7                         |
| Fire & allied lines  | <b>38.0</b>              | 33.8                 | 33.8                              | 4.2                         |
| Other & product liability  | <b>177.1</b>             | 167.1                | 167.1                             | 10.0                        |
| Workers compensation   | <b>103.6</b>             | 103.8                | 103.8                             | (0.2)                       |
| Other commercial   | <b>5.8</b>               | 6.1                  | 6.1                               | (0.3)                       |
| <i>Total business</i>  | <b>513.2</b>             | 493.8                | 493.8                             | 19.4                        |
| <i>Total losses and loss expenses payable net of reinsurance recoverable on losses and loss expenses payable</i> | <b>\$ 870.4</b>          | 819.4                | 815.4                             | 55.0                        |

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- (1) The December 31, 2009 loss and loss expenses payable balance has been adjusted for comparative purposes to reflect the loss and loss expenses payable ceded to the Mutual Pooled Companies on January 1, 2010 due to the 2010 pooling changes.
- (2) Calculated based on June 30, 2010 change from January 1, 2010.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Loss and loss expenses payable increased \$55.0 million since January 1, 2010, primarily due to catastrophe related losses impacting homeowners, commercial multi-peril and fire & allied lines, as well as an increase in large losses for other & product liability occurring in second quarter 2010. We conduct quarterly reviews of loss development reports and make judgments in determining the reserves for ultimate losses and loss expenses payable. Several factors are considered by us when estimating ultimate liabilities including consistency in relative case reserve adequacy, consistency in claims settlement practices, recent legal developments, historical data, actuarial projections, accounting projections, exposure changes, anticipated inflation, current business conditions, catastrophe developments, late reported claims, and other reasonableness tests.

The risks and uncertainties inherent in our estimates include, but are not limited to, actual settlement experience different from historical data, trends, changes in business and economic conditions, court decisions creating unanticipated liabilities, ongoing interpretation of policy provisions by the courts, inconsistent decisions in lawsuits regarding coverage and additional information discovered before settlement of claims. Our results of operations and financial condition could be impacted, perhaps significantly, in the future if the ultimate payments required to settle claims vary from the liability currently recorded. For a discussion of our reserving methodologies as well as a measure of sensitivity discussion see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Loss and Loss Expenses Payable in Item 7 of the 2009 Form 10-K.

*Acquisition and Operating Expenses*

Our GAAP expense ratios were 33.7% and 33.6% for the three and six months ended June 30, 2010, respectively, compared to 33.5% and 33.4% for the same 2009 periods.

In the second quarter of 2009, we initiated a plan to reorganize our field and claims operations. Total restructuring charges, including employee termination benefits, benefit plan curtailment impact, relocation packages, and costs associated with ceasing to use leased properties, are estimated to be approximately \$7.5 million through the fourth quarter 2010, the expected completion date for the reorganization. We recognized restructuring costs totaling \$0.2 million and \$1.6 million during the three and six months ended June 30, 2010, which increased our GAAP Loss and LAE ratios by 0.0 points and 0.2 points, respectively, and our GAAP expense ratios by 0.0 points and 0.1 points, respectively. During the second quarter of 2009, we recognized restructuring costs totaling \$1.0 million, which for the three and six months ended June 30, 2009, increased our GAAP Loss and LAE ratios by 0.2 points and 0.1 points, respectively, and our GAAP expense ratios by 0.2 points and 0.1 points, respectively. See Note 8, Restructuring Costs to our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

**Investment Operations Segment**

At June 30, 2010, our investments in fixed maturity, equity securities and certain other invested assets were held as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are included as a separate component of stockholders equity as accumulated other comprehensive income and as such are not included in the determination of net income.

For further discussion regarding the management of our investment portfolio, see Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations 2009 Compared to 2008 Investment Operations Segment in Item 7 of the 2009 Form 10-K.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

*Composition of Investment Portfolio*

The following table provides the composition of our investment portfolio at carrying value at June 30, 2010 and December 31, 2009, respectively:

| <i>(\$ millions)</i>                              | <b>June 30,<br/>2010</b> | <b>% of<br/>Total</b> | December 31,<br>2009 | % of<br>Total |
|---|--------------------------|-----------------------|----------------------|---------------|
| Cash and cash equivalents                         | \$ 66.0                  | 2.9                   | \$ 90.3              | 4.0           |
| Fixed maturities, at fair value:                  |                          |                       |                      |               |
| Fixed maturities                                  | 1,715.6                  | 74.4                  | 1,691.8              | 74.5          |
| Treasury inflation-protected securities           | 159.4                    | 6.9                   | 140.0                | 6.2           |
| <i>Total fixed maturities</i>                     | <b>1,875.0</b>           | <b>81.3</b>           | 1,831.8              | 80.7          |
| Notes receivable from affiliate                   | 70.0                     | 3.0                   | 70.0                 | 3.1           |
| Equity securities, at fair value:                 |                          |                       |                      |               |
| Large-cap equity securities                       | 194.7                    | 8.4                   | 196.1                | 8.6           |
| Small-cap equity securities                       | 36.0                     | 1.6                   | 28.0                 | 1.2           |
| <i>Total equity securities</i>                    | <b>230.7</b>             | <b>10.0</b>           | 224.1                | 9.8           |
| Other invested assets, at fair value:             |                          |                       |                      |               |
| International instruments                         | 59.1                     | 2.6                   | 48.3                 | 2.1           |
| Other invested assets                             | 3.9                      | 0.1                   | 4.0                  | 0.2           |
| <i>Total other invested assets, at fair value</i> | <b>63.0</b>              | <b>2.7</b>            | 52.3                 | 2.3           |
| Other invested assets, at cost                    | 1.0                      | 0.1                   | 0.9                  | 0.1           |
| <i>Total portfolio</i>                            | <b>\$ 2,305.7</b>        | <b>100.0</b>          | \$ 2,269.4           | 100.0         |

In May 2009, we entered into two separate Credit Agreements with State Auto Mutual. Under these Credit Agreements, State Auto Mutual borrowed a total of \$70.0 million from us on an unsecured basis. Interest is payable at a fixed annual interest rate of 7.00%. Principal is payable May 2019.

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The amortized cost and fair value of unaffiliated fixed maturities at June 30, 2010, by contractual maturity, were as follows:

| <i>(\$ millions)</i>  | Amortized<br>cost | Fair<br>value  |
|---|-------------------|----------------|
| Due in 1 year or less   | \$ 34.1           | 34.2           |
| Due after 1 year through 5 years                                | 301.4             | 310.0          |
| Due after 5 years through 10 years                              | 508.8             | 535.3          |
| Due after 10 years  | 679.1             | 700.7          |
| U.S. government agencies residential mortgage-backed securities | 283.2             | 294.8          |
| <i>Total</i>  | <b>\$ 1,806.6</b> | <b>1,875.0</b> |

Expected maturities may differ from contractual maturities as the issuers may have the right to call or prepay the obligations with or without call or prepayment penalties. The duration of the fixed maturity portfolio was approximately 4.46 years and 4.99 years as of June 30, 2010 and December 31, 2009, respectively.

*Investment Operations Revenue*

Net investment income for the three months ended June 30, 2010 remained flat when compared to the same 2009 period, while increasing \$2.2 million for the six months ended June 30, 2010 compared to the same 2009 period. For the three months ended June 30, 2010, our investment yield decreased to 3.8% from 4.1%, and for the six months ended June 30, 2010, remained consistent at 3.8%, when compared to the same 2009 periods. These changes were primarily due to the following factors.

Between June 30, 2010 and 2009 our Treasury Inflation-Protected Securities ( TIPS ) exposure, at amortized cost, increased to \$152.6 million from \$87.7 million, respectively. During the first six months of 2010, the TIPS amortized cost value, which is dependent on changes in the CPI Index, increased by \$1.5 million compared to a decline of \$0.9 million in the same 2009 period, while the change for the three month period was flat.

Interest earned on notes receivable from affiliate was \$1.2 million and \$2.4 million for the three and six months ended June 30, 2010, compared to \$0.7 for both the three and six months ended June 30, 2009. Our Credit Agreements with State Auto Mutual were entered into during the second quarter of 2009.

An increase in the amount of high dividend paying equities held when compared to 2009.

These increases were partially offset by a decline in returns on fixed income securities due to a shift in this portfolio where we are now holding fewer long duration tax exempt bonds earning higher rates of return to holding higher levels of taxable bonds with shorter durations and lower rates of return compared to the same 2009 period.



STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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| (\$ millions)                          | Three months ended<br>June 30 |         | Six months ended<br>June 30 |         |
|--|-------------------------------|---------|-----------------------------|---------|
|  | 2010                          | 2009    | 2010                        | 2009    |
| <b>Gross investment income:</b>        |                               |         |                             |         |
| Fixed income securities                | \$ 18.5                       | 19.5    | \$ 37.0                     | 36.7    |
| Equity securities                      | 1.5                           | 0.8     | 2.6                         | 1.7     |
| Other                                  | 1.4                           | 0.8     | 2.7                         | 1.3     |
| <i>Total gross investment income</i>   | <b>21.4</b>                   | 21.1    | <b>42.3</b>                 | 39.7    |
| Less: Investment expenses              | 0.6                           | 0.3     | 1.0                         | 0.6     |
| <i>Net investment income</i>           | <b>\$ 20.8</b>                | 20.8    | <b>\$ 41.3</b>              | 39.1    |
| Average invested assets (at cost)      | \$ 2,206.5                    | 2,043.9 | \$ 2,198.5                  | 2,065.5 |
| Annualized investment yield            | 3.8%                          | 4.1     | 3.8%                        | 3.8     |
| Annualized investment yield, after tax | 3.1%                          | 3.5     | 3.1%                        | 3.4     |
| Net investment income, after tax       | \$ 16.8                       | 18.0    | \$ 33.6                     | 34.7    |
| Effective tax rate                     | 19.2%                         | 13.6    | 18.7%                       | 11.4    |

Realized gains and losses on investments are summarized as follows:

| (\$ millions)                            | Three months ended<br>June 30, 2010 |                                 | Six months ended<br>June 30, 2010 |                                 |
|--|-------------------------------------|---------------------------------|-----------------------------------|---------------------------------|
|  | Realized<br>gains<br>(losses)       | Proceeds<br>received<br>on sale | Realized<br>gains<br>(losses)     | Proceeds<br>received<br>on sale |
| <b>Realized gains:</b>                   |                                     |                                 |                                   |                                 |
| Fixed maturities                         | \$ 0.2                              | 14.6                            | \$ 1.1                            | 51.4                            |
| Equity securities                        | 3.4                                 | 15.3                            | 7.3                               | 29.9                            |
| <i>Total realized gains</i>              | <b>3.6</b>                          | <b>29.9</b>                     | <b>8.4</b>                        | <b>81.3</b>                     |
| <b>Realized losses:</b>                  |                                     |                                 |                                   |                                 |
| Fixed maturities                         |                                     |                                 |                                   |                                 |
| Equity securities:                       |                                     |                                 |                                   |                                 |
| Sales                                    | (1.7)                               | 7.7                             | (2.5)                             | 12.6                            |
| OTTI                                     | (1.6)                               |                                 | (2.4)                             |                                 |
| <i>Total realized losses</i>             | <b>(3.3)</b>                        | <b>7.7</b>                      | <b>(4.9)</b>                      | <b>12.6</b>                     |
| <i>Net realized gains on investments</i> | <b>\$ 0.3</b>                       | <b>37.6</b>                     | <b>\$ 3.5</b>                     | <b>93.9</b>                     |

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

During the three and six months ended June 30, 2010, several of our fixed maturities, principally municipal bonds, were sold to reduce the risk of over-exposure in certain geographic areas or issuers, resulting in realized gains. Proceeds from the bonds were used to purchase taxable bonds. Equity sales were executed for various reasons in 2010, including the achievement of our price target. We recognized realized losses on the sale of three large-cap equity securities in response to a continuing decline in stock price and negative outlook announcements which in our opinion diminished the future business prospects on these securities.

When a fixed maturity security has been determined to have an other-than-temporary decline in fair value, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income (loss). See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Investments included in Item 7 of the 2009 Form 10-K for other-than-temporary impairment ( OTTI ) indicators. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income (loss). We did not recognize OTTI on our fixed maturity portfolio for the three and six months ended June 30, 2010 or 2009.

When an equity security or other invested asset has been determined to have a decline in fair value that is other-than-temporary, we adjust the cost basis of the security to fair value. See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Investments included in Item 7 of the 2009 Form 10-K for OTTI impairment indicators. This results in a charge to earnings as a realized loss, which is not reversed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income (loss).

The following table provides a detailed breakdown of OTTI charges by security type:

| (\$ millions, except # of positions) | Three months ended<br>June 30, 2010 |                     | Six months ended<br>June 30, 2010 |                     |
|--------------------------------------|-------------------------------------|---------------------|-----------------------------------|---------------------|
|                                      | Number of<br>positions              | Total<br>impairment | Number of<br>positions            | Total<br>impairment |
| Equity securities:                   |                                     |                     |                                   |                     |
| Large-cap equity securities          |                                     | \$                  | 1                                 | \$ (0.3)            |
| Small-cap equity securities          | 29                                  | (1.6)               | 46                                | (2.1)               |
| <i>Total OTTI</i>                    | 29                                  | \$ (1.6)            | 47                                | \$ (2.4)            |

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

*Gross Unrealized Investment Gains and Losses*

The following table provides detailed information on our available-for-sale investment portfolio at fair value for our gross unrealized gains and losses at June 30, 2010:

(\$ millions, except # of positions)

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>holding<br>gains | Number<br>of gain<br>positions | Gross<br>unrealized<br>holding<br>losses | Number<br>of loss<br>positions | Fair<br>value     |
|--|------------------------------|---|--------------------------------|--|--------------------------------|-------------------|
| <b><u>Fixed maturities:</u></b>                                      |                              |   |                                |  |                                |                   |
| U.S. treasury securities and obligations of U.S. government agencies | \$ 452.9                     | \$ 13.0                                 | 133                            | \$                                       | 2                              | \$ 465.9          |
| Obligations of states and political subdivisions                     | 957.0                        | 37.4                                    | 416                            | (0.7)                                    | 25                             | 993.7             |
| Corporate securities   | 113.5                        | 7.1                                     | 63                             |  |                                | 120.6             |
| U.S. government agencies residential mortgage-backed securities      | 283.2                        | 12.0                                    | 91                             | (0.4)                                    | 11                             | 294.8             |
| <i>Total fixed maturities</i>  | <b>1,806.6</b>               | <b>69.5</b>                             | <b>703</b>                     | <b>(1.1)</b>                             | <b>38</b>                      | <b>1,875.0</b>    |
| <b><u>Equity securities:</u></b>                                     |                              |   |                                |  |                                |                   |
| Large-cap equity securities  | 183.1                        | 21.2                                    | 39                             | (9.6)                                    | 36                             | 194.7             |
| Small-cap equity securities  | 33.0                         | 3.0                                     | 43                             |  |                                | 36.0              |
| <i>Total equity securities</i>                                       | <b>216.1</b>                 | <b>24.2</b>                             | <b>82</b>                      | <b>(9.6)</b>                             | <b>36</b>                      | <b>230.7</b>      |
| Other invested assets  | 60.1                         | 3.5                                     | 3                              | (0.6)                                    | 2                              | 63.0              |
| <i>Total available-for-sale investments</i>                          | <b>\$ 2,082.8</b>            | <b>\$ 97.2</b>                          | <b>788</b>                     | <b>\$ (11.3)</b>                         | <b>76</b>                      | <b>\$ 2,168.7</b> |

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

The following table presents a summary of our unrealized gains by investment type, net of deferred tax that was included as a component of accumulated comprehensive income (loss) at June 30, 2010 and December 31, 2009, respectively, and the change in unrealized gains, net of deferred tax, for the three months ended June 30, 2010:

| <i>(\$ millions)</i>                          | <b>June 30,<br/>2010</b> | December 31,<br>2009 | \$<br>Change |
|---|--------------------------|----------------------|--------------|
| <b><u>Available-for-sale investments:</u></b> |                          |                      |              |
| Unrealized holding gains:                     |                          |                      |              |
| Fixed maturities                              | <b>\$ 68.4</b>           | 43.7                 | 24.7         |
| Equity securities                             | <b>14.6</b>              | 34.4                 | (19.8)       |
| Other invested assets                         | <b>2.9</b>               | 8.2                  | (5.3)        |
| <i>Unrealized gains</i>                       | <b>85.9</b>              | 86.3                 | (0.4)        |
| Deferred federal income tax liability         | <b>(30.1)</b>            | (30.2)               | 0.1          |
| <i>Unrealized gains, net of tax</i>           | <b>\$ 55.8</b>           | 56.1                 | (0.3)        |

*Fair Value Measurements*

We primarily use one independent nationally recognized pricing service in developing fair value estimates. We obtain one price per security, and our processes and control procedures are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, we gain an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, we compare to other fair value pricing information gathered from other independent pricing sources. See Note 3, Fair Value of Financial Instruments to our Condensed Consolidated Financial Statements included in Item 1 of this Form 10-Q for a presentation of our available-for-sale investments within the fair value hierarchy at June 30, 2010 and December 31, 2009.

As of June 30, 2010, Level 3 assets as a percentage of total assets were 0.1% which we have determined to be insignificant.

**Other Income Statement Items**

Federal income tax (benefit) expense for the three and six months ended June 30, 2010 was \$(3.8) million and \$3.9 million, respectively. Federal income tax (benefit) expense for the three and six months ended June 30, 2010 was determined using an annual effective tax rate for 2010. We would have had a tax benefit for the six month period but for a one-time tax charge of \$4.5 million which was recognized in the first quarter 2010 related to the recently enacted federal health care legislation. This legislation eliminated the tax benefit associated with Medicare Part D subsidies we receive for providing qualifying prescription drug coverage to retirees.

For the six months ended June 30, 2009, the uncertainty of the Company's expected full year results at the time precluded the Company from making a reliable estimate of the annual effective tax rate. Accordingly, we recorded a tax benefit based on the actual results for the six months ended June 30, 2009.



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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

## LIQUIDITY AND CAPITAL RESOURCES

### General

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

We maintain a portion of our investment portfolio in relatively short-term and highly liquid investments to ensure the immediate availability of funds to pay claims and expenses. At June 30, 2010 and December 31, 2009, we had \$66.0 million and \$90.3 million, respectively, in cash and cash equivalents, and \$2,168.7 million and \$2,108.2 million, respectively, of total available-for-sale investments at fair value. Included in our fixed maturities available-for-sale at fair value was \$66.4 million and \$56.9 million of securities on deposit with insurance regulators as required by law at June 30, 2010 and December 31, 2009, respectively. In addition, substantially all of our fixed maturity and equity securities are traded in public markets.

Our insurance subsidiaries must have adequate liquidity to ensure that their cash obligations are met. However, because the STFC Pooled Companies participate in the Pooling Arrangement, they do not have the daily liquidity concerns normally associated with an insurance company. This is because under the terms of the Pooling Arrangement, State Auto Mutual receives all premiums and pays all losses and expenses associated with the insurance business produced by the pool participants and then settles the intercompany balances generated by these transactions with the participating companies within 45 days following each quarter end.

When settling the intercompany balances, State Auto Mutual provides the pool participants with full credit for the premiums written and net losses paid during the quarter and retains all receivable amounts from insureds and agents and reinsurance recoverable on paid losses from unaffiliated reinsurers. Any receivable amounts that are ultimately deemed to be uncollectible are charged-off by State Auto Mutual and allocated to the pool member on the basis of pool participation. As a result, we have an off-balance sheet credit risk related to the balances due to State Auto Mutual from insureds, agents and reinsurers, which are offset by the unearned premium from the respective policies. While the total amount due to State Auto Mutual from policyholders and agents is significant, the individual amounts due are relatively small at the policyholder and agency level. Based on historical data, this credit-risk exposure is not considered to be material to our financial position, though the impact to income on a quarterly basis may be material. The State Auto Group mitigates its exposure to this credit risk through its in-house collections unit for both personal and commercial accounts which is supplemented by third party collection service providers. The amounts deemed uncollectible by State Auto Mutual and allocated to the STFC Pooled Companies are included in other expenses in the accompanying consolidated statements of income.

Net cash provided by operating activities was \$42.9 million for the first six months of 2010 compared to \$5.1 million for the same 2009 period. Net cash from operations will vary from period to period if there are significant changes in underwriting results, primarily the level of premiums written or loss and loss expenses paid, and in cash flows from investment income or in federal income taxes paid. The increase in net cash provided by operating activities in the second quarter 2010 was primarily the result of an increase in the level of premiums received and a reduction in the level of loss and loss expenses paid. We made a \$4.0 million cash contribution to the defined benefit plan during the first six months of 2010 compared to a cash contribution of \$10.0 million in the same 2009 period.

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Net cash used in investing activities was \$57.5 million during first six months of 2010 compared to \$41.1 million in the same 2009 period. During early 2009 we maintained higher cash balances to avoid selling assets at depressed prices for any cash needs that might arise in the course of business such as settling claims associated with the high level of catastrophes that occurred in first quarter 2009 and in late 2008.

Net cash used in financing activities was \$9.7 million during the first six months of 2010 compared to \$10.0 million during the same 2009 period.

On May 7, 2010, the Board of Directors of State Auto Financial declared a cash dividend of \$0.15 per share. The dividend was payable on June 30, 2010, to shareholders of record on June 14, 2010. This is the 76<sup>th</sup> consecutive quarterly cash dividend declared by State Auto Financial's Board since we had our initial public offering of common stock on June 28, 1991.

During the second quarter 2010, SA National paid a dividend of \$40.0 million to State Auto Financial, and State Auto Financial made a capital contribution of \$21.0 million to State Auto P&C. The SA National dividend was considered extraordinary for regulatory purposes.

### **Borrowing Arrangements**

#### *Credit Agreement*

State Auto Financial has a credit facility (the Credit Facility) with a syndicate of financial institutions. The Credit Facility provides for a \$100.0 million unsecured revolving credit facility maturing in July 2012. The Credit Facility is available for general corporate purposes. The Credit Facility provides for interest-only payments during its term, with principal and interest due in full at maturity. Interest is based on a London interbank market rate or a base rate plus a calculated margin amount. The 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. As of June 30, 2010, State Auto Financial had not made any borrowings and was in compliance with all covenants related to the Credit Facility.

#### *Senior Notes*

State Auto Financial has outstanding \$100.0 million of unsecured Senior Notes due November 2013. The Senior Notes bear interest at a fixed rate of 6.25% per annum, which is payable each May 15 and November 15. The Senior Notes are general unsecured obligations ranking senior to all existing and future subordinated indebtedness and equal with all existing and future senior indebtedness. The Senior Notes are not guaranteed by any of State Auto Financial's subsidiaries and thereby are effectively subordinated to all State Auto Financial's subsidiaries existing and future indebtedness.

#### *Subordinated Debentures*

State Auto Financial's Delaware business trust subsidiary (the Capital Trust) has outstanding \$15.0 million liquidation amount of capital securities, due 2033. In connection with the Capital Trust's issuance of the capital securities and the related purchase by State Auto Financial of all of the Capital Trust's common securities (liquidation amount of \$0.5 million), State Auto Financial has issued to the Capital Trust \$15.5 million aggregate principal amount of unsecured Floating Rate Junior Subordinated Debt Securities due 2033 (the Subordinated Debentures). The sole assets of the Capital Trust are the Subordinated Debentures and any interest accrued thereon. Interest on the Capital Trust's capital and common securities is payable quarterly at a rate equal to the three-month LIBOR rate plus 4.20%, adjusted quarterly. The applicable interest rates for June 30, 2010 and 2009 were 4.7% and 4.9%, respectively.

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**Reinsurance Arrangements**

Members of the State Auto Group follow the customary industry practice of reinsuring a portion of their exposures and paying to the reinsurers a portion of the premiums received. Insurance is ceded principally to reduce net liability on individual risks or for individual loss occurrences, including catastrophic losses. Although reinsurance does not legally discharge the individual members of the State Auto Group from primary liability for the full amount of limits applicable under their policies, it does make the assuming reinsurer liable to the extent of the reinsurance ceded.

As of January 1, 2010, members of the State Auto Group renewed their CAT Aggregate Agreement, a net aggregate excess of loss reinsurance agreement which covers PCS numbered catastrophes, excluding earthquakes and named storms such as hurricanes and tropical storms. Under the terms of the renewal, on an aggregate basis, the members of the State Auto Group combined retain the first \$90.0 million of covered loss. During 2009, the aggregate retention under this agreement was \$80.0 million.

As of July 1, 2010, we reviewed and renewed our property per risk, property catastrophe, casualty, workers' compensation and workers' compensation catastrophe reinsurance programs. There were no material changes to the terms of these reinsurance programs, and the change in cost is not expected to be material to our quarter or year to date results of operations.

The State Auto Group's reliance on ceded reinsurance is not significant in comparison to the State Auto Group's total statutory surplus or our total financial position. To minimize the risk of reinsurer default, the State Auto Group cedes only to third-party reinsurers who are rated A- or better by A.M. Best and also utilizes both domestic and international markets to diversify its credit risk. We utilize reinsurance to limit our loss exposure and contribute to our liquidity and capital resources.

Except as described in the preceding paragraphs, there have been no material changes in our reinsurance arrangements since December 31, 2009. For a discussion of our reinsurance arrangements, see Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Reinsurance Arrangements in Item 7 of the 2009 Form 10-K.

**Regulatory Considerations**

At June 30, 2010, all of our insurance subsidiaries were in compliance with statutory requirements relating to capital adequacy.



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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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**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 our 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. We 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 Note 3 of the accompanying condensed consolidated financial statements.

**MARKET RISK**

With respect to Market Risk, see the discussion regarding this subject at Management's Discussion and Analysis of Financial Condition and Results of Operations 2009 Compared to 2008 Investment Operations Segment Market Risk in Item 7 of the 2009 Form 10-K. There have been no material changes from the information reported regarding Market Risk in the 2009 Form 10-K.

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**Item 3. Quantitative and Qualitative Disclosure of Market Risk**

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

**Item 4. Controls and Procedures**

**Disclosure Controls and Procedures**

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

1. Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission;
2. Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure; and
3. Our disclosure controls and procedures are effective in timely making known to them material information required to be included in our periodic filings with the Securities and Exchange Commission.

**Changes in Internal Control over Financial Reporting**

There has been no change in our internal controls over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in the 2009 Form 10-K under Part I, Item 1A Risk Factors.

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

Issuer Purchases of Equity Securities

| Period                 | Total Number of Shares Purchased (in whole numbers) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased under the Plans or Programs |
|------------------------|---|------------------------------|--|--|
| 04/01/10 thru 04/30/10 |   |                              |  |  |
| 05/01/10 thru 05/31/10 | 4,765 <sup>(1)</sup>                                | 19.04                        |  |  |
| 06/01/10 thru 06/30/10 |   |                              |  |  |
| Total                  | 4,765   | \$ 19.04                     |  |  |

<sup>(1)</sup> These shares acquired as a result of stock option exercises.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. (Removed and Reserved)**

**Item 5. Other Information**

None.

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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**Item 6. Exhibits**

| Exhibit No. | Description of Exhibits  |
|-------------|--|
| 10.01       | Supplemental Retirement Plan for Executive Employees of State Auto Insurance Companies, Amended and Restated as of May 1, 2010   |
| 10.02       | First Amendment to the State Auto Property & Casualty Insurance Company Amended and Restated Incentive Deferred Compensation Plan (amendment effective as of July 1, 2010) |
| 31.01       | CEO certification required by Section 302 of Sarbanes Oxley Act of 2002  |
| 31.02       | CFO certification required by Section 302 of Sarbanes Oxley Act of 2002  |
| 32.01       | CEO certification required by Section 906 of Sarbanes Oxley Act of 2002  |
| 32.02       | CFO certification required by Section 906 of Sarbanes Oxley Act of 2002  |

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**SIGNATURE**

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

Date: August 5, 2010

**State Auto Financial Corporation**

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