

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

State Auto Financial CORP

Form 10-Q

November 07, 2016

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**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 September 30, 2016

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 43215-3976**

(Address of principal executive offices)

(Zip Code)

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

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

Yes  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, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Yes  No

On October 28, 2016, the Registrant had 41,742,438 Common Shares outstanding.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

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

	<b>September 30, 2016</b>	December 31, 2015
	(unaudited)	
<b>Assets</b>		
Fixed maturities, available-for-sale, at fair value (amortized cost \$2,061.0 and \$1,972.9, respectively)	<b>\$ 2,143.3</b>	\$2,000.7
Equity securities, available-for-sale, at fair value (cost \$246.1 and \$265.2, respectively)	<b>297.5</b>	310.6
Other invested assets, available-for-sale, at fair value (cost \$57.1 and \$56.9, respectively)	<b>89.7</b>	85.1
Other invested assets	<b>5.4</b>	5.3
Notes receivable from affiliate	<b>70.0</b>	70.0
<i>Total investments</i>	<b>2,605.9</b>	2,471.7
Cash and cash equivalents	<b>69.5</b>	58.1
Accrued investment income and other assets	<b>39.0</b>	35.7
Deferred policy acquisition costs (affiliated net assumed \$52.8 and \$49.3, respectively)	<b>133.8</b>	129.1
Reinsurance recoverable on losses and loss expenses payable	<b>4.1</b>	5.9
Prepaid reinsurance premiums	<b>6.1</b>	6.8
Due from affiliate	<b>21.2</b>	5.9
Current federal income taxes	<b>6.4</b>	4.9
Net deferred federal income taxes	<b>76.6</b>	102.5
Property and equipment, at cost	<b>7.4</b>	7.6
<b>Total assets</b>	<b>\$ 2,970.0</b>	\$2,828.2
<b>Liabilities and Stockholders' Equity</b>		
Losses and loss expenses payable (affiliated net assumed \$606.7 and \$532.4, respectively)	<b>\$ 1,165.6</b>	\$1,053.0
Unearned premiums (affiliated net assumed \$227.0 and \$214.2, respectively)	<b>634.2</b>	616.3
Notes payable (affiliates \$15.2 and \$15.2, respectively)	<b>122.1</b>	100.5
Postretirement and pension benefits (affiliated net ceded \$38.4 and \$56.0, respectively)	<b>71.4</b>	104.0
Other liabilities (affiliated net assumed \$10.5 and affiliated net ceded \$8.4, respectively)	<b>68.9</b>	69.8
<b>Total liabilities</b>	<b>2,062.2</b>	1,943.6
Stockholders' equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued	—	—
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued	—	—
Common stock, without par value. Authorized 100.0 shares; 48.4 and 48.1 shares issued, respectively, at stated value of \$2.50 per share	<b>121.1</b>	120.4
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	<b>(116.5)</b>	(116.3)
Additional paid-in capital	<b>156.0</b>	153.5
Accumulated other comprehensive income (affiliated net ceded \$53.3 and \$56.7, respectively)	<b>81.7</b>	37.6
Retained earnings	<b>665.5</b>	689.4
<b>Total stockholders' equity</b>	<b>907.8</b>	884.6
<b>Total liabilities and stockholders' equity</b>	<b>\$ 2,970.0</b>	\$2,828.2

See accompanying notes to condensed consolidated financial statements.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Condensed Consolidated Statements of Income**

	Three months ended September 30	
	<b>2016</b>	2015
<i>(\$ in millions, except per share amounts)</i>		
(unaudited)		
Earned premiums (affiliated net assumed \$121.4 and \$112.2, respectively)	<b>\$325.8</b>	\$319.7
Net investment income (affiliates \$1.3 and \$1.3, respectively)	<b>17.6</b>	18.7
Net realized gains on investments:		
Total other-than-temporary impairment losses	<b>(1.1 )</b>	(3.5 )
Portion of loss recognized in other comprehensive income	—	—
Other net realized investment gains	<b>9.9</b>	14.3
Total net realized gains on investments	<b>8.8</b>	10.8
Other income from affiliates	<b>0.6</b>	0.5
<b>Total revenues</b>	<b>352.8</b>	349.7
Losses and loss expenses (affiliated net assumed \$100.9 and \$67.4, respectively)	<b>232.3</b>	207.5
Acquisition and operating expenses (affiliated net assumed \$73.9 and \$52.8, respectively)	<b>109.9</b>	109.4
Interest expense (affiliates \$0.2 and \$0.1, respectively)	<b>1.4</b>	1.3
Other expenses	<b>1.8</b>	1.6
<b>Total expenses</b>	<b>345.4</b>	319.8
<b>Income before federal income taxes</b>	<b>7.4</b>	29.9
Federal income tax (benefit) expense:		
Current	<b>(1.5 )</b>	2.7
Deferred	<b>(1.2 )</b>	6.5
<b>Total federal income tax (benefit) expense</b>	<b>(2.7 )</b>	9.2
<b>Net income</b>	<b>\$10.1</b>	\$20.7
Earnings per common share:		
Basic	<b>\$0.24</b>	\$0.50
Diluted	<b>\$0.24</b>	\$0.50
Dividends paid per common share	<b>\$0.10</b>	\$0.10

See accompanying notes to condensed consolidated financial statements.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Condensed Consolidated Statements of Income**

	Nine months ended September 30	
(unaudited)	<b>2016</b>	2015
Earned premiums (affiliated net assumed \$352.4 and \$320.5, respectively)	<b>\$968.1</b>	\$946.5
Net investment income (affiliates \$3.7 and \$3.7, respectively)	<b>54.1</b>	53.9
Net realized gains on investments:		
Total other-than-temporary impairment losses	<b>(5.4 )</b>	(4.8 )
Portion of loss recognized in other comprehensive income	—	—
Other net realized investment gains	<b>22.0</b>	24.8
Total net realized gains on investments	<b>16.6</b>	20.0
Other income from affiliates	<b>1.7</b>	1.6
<b>Total revenues</b>	<b>1,040.5</b>	1,022.0
Losses and loss expenses (affiliated net assumed \$281.4 and \$200.9, respectively)	<b>720.2</b>	627.1
Acquisition and operating expenses (affiliated net assumed \$217.0 and \$188.9, respectively)	<b>324.6</b>	318.7
Interest expense (affiliates \$0.6 and \$0.5, respectively)	<b>4.1</b>	4.0
Other expenses	<b>5.5</b>	5.7
<b>Total expenses</b>	<b>1,054.4</b>	955.5
<b>(Loss) income before federal income taxes</b>	<b>(13.9 )</b>	66.5
Federal income tax (benefit) expense:		
Current	<b>(1.5 )</b>	3.3
Deferred	<b>(0.9 )</b>	15.1
<b>Total federal income tax (benefit) expense</b>	<b>(2.4 )</b>	18.4
<b>Net (loss) income</b>	<b>\$(11.5)</b>	\$48.1
(Loss) earnings per common share:		
Basic	<b>\$(0.28)</b>	\$1.17
Diluted	<b>\$(0.28)</b>	\$1.16
Dividends paid per common share	<b>\$0.30</b>	\$0.30

See accompanying notes to condensed consolidated financial statements.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Consolidated Statements of Comprehensive Income**

	Three months ended	
	September 30	
(unaudited)	2016	2015
Net income	\$10.1	\$20.7
Other comprehensive loss, net of tax:		
Net unrealized holding gains (losses) on investments:		
Unrealized holding gains (losses)	6.3	(24.5 )
Reclassification adjustments for gains realized in net income	(8.8 )	(10.8 )
Income tax benefit	0.8	12.4
<i>Total net unrealized holding losses on investments</i>	<b>(1.7 )</b>	<b>(22.9 )</b>
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Negative prior service cost	(1.3 )	(1.3 )
Net actuarial loss	2.4	2.8
Income tax expense	(0.4 )	(0.6 )
<i>Total net unrecognized benefit plan obligations</i>	<b>0.7</b>	<b>0.9</b>
<i>Other comprehensive loss</i>	<b>(1.0 )</b>	<b>(22.0 )</b>
<b>Comprehensive income (loss)</b>	<b>\$9.1</b>	<b>\$(1.3 )</b>

See accompanying notes to condensed consolidated financial statements.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Consolidated Statements of Comprehensive Income**

	Nine months ended September 30	
	2016	2015
<i>(\$ in millions, except per share amounts)</i>		
(unaudited)		
Net (loss) income	<b>\$(11.5)</b>	\$48.1
Other comprehensive income (loss), net of tax:		
Net unrealized holding gains (losses) on investments:		
Unrealized holding gains (losses)	<b>81.5</b>	(46.1 )
Reclassification adjustments for gains realized in net income	<b>(16.6 )</b>	(20.4 )
Income tax (expense) benefit	<b>(22.8 )</b>	23.3
<i>Total net unrealized holding gains (losses) on investments</i>	<b>42.1</b>	(43.2 )
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Negative prior service cost	<b>(4.1 )</b>	(4.1 )
Net actuarial loss	<b>7.1</b>	8.6
Income tax expense	<b>(1.0 )</b>	(1.6 )
<i>Total net unrecognized benefit plan obligations</i>	<b>2.0</b>	2.9
<i>Other comprehensive income (loss)</i>	<b>44.1</b>	(40.3 )
<b>Comprehensive income</b>	<b>\$32.6</b>	\$7.8

See accompanying notes to condensed consolidated financial statements.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Condensed Consolidated Statements of Cash Flows**

	Nine months ended September 30	
	2016	2015
<i>(\$ in millions)</i>		
(unaudited)		
<b>Cash flows from operating activities:</b>		
Net (loss) income	<b>\$(11.5)</b>	\$48.1
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	<b>11.5</b>	10.8
Share-based compensation	<b>3.2</b>	5.1
Net realized gains on investments	<b>(16.6)</b>	(20.0)
Changes in operating assets and liabilities:		
Deferred policy acquisition benefits	<b>(4.7)</b>	(7.5)
Accrued investment income and other assets	<b>(3.4)</b>	(4.5)
Postretirement and pension benefits	<b>(30.6)</b>	(5.8)
Other liabilities and due to/from affiliates, net	<b>(17.4)</b>	(63.5)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	<b>2.5</b>	1.2
Losses and loss expenses payable	<b>112.6</b>	38.3
Unearned premiums	<b>17.9</b>	25.1
Excess tax benefits on share-based awards	<b>(0.1)</b>	0.1
Federal income taxes	<b>(1.4)</b>	17.6
Cash provided from December 31, 2014 unearned premium transfer related to the homeowners quota share arrangement	<b>—</b>	63.5
<b><i>Net cash provided by operating activities</i></b>	<b>62.0</b>	108.5
<b>Cash flows from investing activities:</b>		
Purchases of fixed maturities available-for-sale	<b>(414.6)</b>	(459.8)
Purchases of equity securities available-for-sale	<b>(77.9)</b>	(131.8)
Purchases of other invested assets	<b>(1.0)</b>	(6.5)
Maturities, calls and pay downs of fixed maturities available-for-sale	<b>177.1</b>	203.4
Sales of fixed maturities available-for-sale	<b>138.0</b>	142.7
Sales of equity securities available-for-sale	<b>113.9</b>	117.4
Sales of other invested assets available-for-sale	<b>0.7</b>	0.5
Net additions of property and equipment	<b>—</b>	(0.1)
<b><i>Net cash used in investing activities</i></b>	<b>(63.8)</b>	(134.2)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	<b>4.2</b>	2.9
Payments to acquire treasury stock	<b>(0.2)</b>	(0.3)
Payment of dividends	<b>(12.4)</b>	(12.3)
Excess tax benefits on share-based awards	<b>0.1</b>	—
Proceeds from long-term debt	<b>21.5</b>	—
<b><i>Net cash provided by (used in) financing activities</i></b>	<b>13.2</b>	(9.7)
Net increase (decrease) in cash and cash equivalents	<b>11.4</b>	(35.4)
Cash and cash equivalents at beginning of period	<b>58.1</b>	86.3
<b>Cash and cash equivalents at end of period</b>	<b>\$69.5</b>	\$50.9
<u>Supplemental disclosures:</u>		
Interest paid (affiliates \$0.6 and \$0.5, respectively)	<b>\$4.0</b>	\$3.9

Federal income taxes paid

\$— \$2.4

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements (Unaudited)

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries (“State Auto Financial” or the “Company”) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month period ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. The balance sheet at December 31, 2015 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, 2015 (the “2015 Form 10-K”). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2015 Form 10-K.

**Adoption of Recent Accounting Pronouncements**

*Simplifying the Presentation of Debt Issuance Costs*

The amendments in this guidance simplify the presentation of debt issuance costs by requiring them to be presented in the balance sheet as a direct deduction from the carrying amount of the related recognized debt liability, consistent with debt discounts. The Company adopted this guidance at January 1, 2016 on a retrospective basis and it resulted in a \$0.3 million decrease to notes payable and accrued investment income and other assets at December 31, 2015.

*Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*

The amendments in this guidance remove the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years and should be applied retrospectively to all periods presented. The Company adopted this guidance at January 1, 2016 and it did not have a material impact on the condensed consolidated financial statements.

**Pending Adoption of Recent Accounting Pronouncements**

*Improvements to Employee Share-Based Payment Accounting*

The amendments in this guidance simplify the accounting for share-based payment award transactions including: income tax consequences, classification of awards as either equity or liabilities, classification of excess tax benefits, and classification on the statement of cash flows. The guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, and early adoption is permitted. The Company is currently evaluating the requirements of the guidance and has not yet determined its effect on the Company’s results of operations, financial position or liquidity.



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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**2. Investments**

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at September 30, 2016 and December 31, 2015:

(\$ millions)

**September 30, 2016**

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$316.8	\$14.3	\$(0.2)	\$330.9
Obligations of states and political subdivisions	664.1	34.5	—	698.6
Corporate securities	510.4	13.1	(0.6)	522.9
U.S. government agencies mortgage-backed securities	569.7	22.4	(1.2)	590.9
<i>Total fixed maturities</i>	<b>2,061.0</b>	<b>84.3</b>	<b>(2.0)</b>	<b>2,143.3</b>
Equity securities:				
Large-cap securities	193.1	37.1	(4.6)	225.6
Small-cap securities	53.0	18.9	—	71.9
<i>Total equity securities</i>	<b>246.1</b>	<b>56.0</b>	<b>(4.6)</b>	<b>297.5</b>
Other invested assets	57.1	32.6	—	89.7
<i>Total available-for-sale securities</i>	<b>\$2,364.2</b>	<b>\$172.9</b>	<b>\$(6.6)</b>	<b>\$2,530.5</b>

(\$ millions)

## December 31, 2015

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$219.8	\$6.6	\$(2.0)	\$224.4
Obligations of states and political subdivisions	804.0	22.5	(1.7)	824.8
Corporate securities	500.3	5.8	(11.7)	494.4
U.S. government agencies mortgage-backed securities	448.8	11.5	(3.2)	457.1
<i>Total fixed maturities</i>	<b>1,972.9</b>	<b>46.4</b>	<b>(18.6)</b>	<b>2,000.7</b>
Equity securities:				
Large-cap securities	211.9	34.2	(5.1)	241.0
Small-cap securities	53.3	16.5	(0.2)	69.6
<i>Total equity securities</i>	<b>265.2</b>	<b>50.7</b>	<b>(5.3)</b>	<b>310.6</b>
Other invested assets	56.9	28.3	(0.1)	85.1
<i>Total available-for-sale securities</i>	<b>\$2,295.0</b>	<b>\$125.4</b>	<b>\$(24.0)</b>	<b>\$2,396.4</b>

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's gross unrealized losses and fair value on its investments by lot, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at September 30, 2016 and December 31, 2015:

(\$ 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>September 30, 2016</b>									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$107.6	\$(0.2)	8	\$—	\$—	—	\$107.6	\$(0.2)	8
Corporate securities	33.8	(0.3)	5	37.3	(0.3)	5	71.1	(0.6)	10
U.S. government agencies mortgage-backed securities	95.6	(0.6)	11	21.1	(0.6)	9	116.7	(1.2)	20
<i>Total fixed maturities</i>	<b>237.0</b>	<b>(1.1)</b>	<b>24</b>	<b>58.4</b>	<b>(0.9)</b>	<b>14</b>	<b>295.4</b>	<b>(2.0)</b>	<b>38</b>
Equity securities:									
Large-cap equity securities	39.9	(3.6)	11	6.9	(1.0)	5	46.8	(4.6)	16
<i>Total temporarily impaired securities</i>	<b>\$276.9</b>	<b>\$(4.7)</b>	<b>35</b>	<b>\$65.3</b>	<b>\$(1.9)</b>	<b>19</b>	<b>\$342.2</b>	<b>\$(6.6)</b>	<b>54</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>December 31, 2015</b>									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$68.6	\$(1.6)	15	\$13.5	\$(0.4)	4	\$82.1	\$(2.0)	19
Obligations of states and political subdivisions	137.5	(1.7)	16	—	—	—	137.5	(1.7)	16
Corporate securities	246.9	(5.3)	36	63.9	(6.4)	11	310.8	(11.7)	47
U.S. government agencies mortgage-backed securities	132.2	(2.3)	18	33.0	(0.9)	11	165.2	(3.2)	29
<i>Total fixed maturities</i>	<b>585.2</b>	<b>(10.9)</b>	<b>85</b>	<b>110.4</b>	<b>(7.7)</b>	<b>26</b>	<b>695.6</b>	<b>(18.6)</b>	<b>111</b>
Equity securities:									
Large-cap equity securities	65.8	(5.1)	24	—	—	—	65.8	(5.1)	24
Small-cap equity securities	3.4	(0.2)	1	—	—	—	3.4	(0.2)	1
<i>Total equity securities</i>	<b>69.2</b>	<b>(5.3)</b>	<b>25</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>69.2</b>	<b>(5.3)</b>	<b>25</b>
Other invested assets	8.1	(0.1)	1	—	—	—	8.1	(0.1)	1
<i>Total temporarily impaired securities</i>	<b>\$662.5</b>	<b>\$(16.3)</b>	<b>111</b>	<b>\$110.4</b>	<b>\$(7.7)</b>	<b>26</b>	<b>\$772.9</b>	<b>\$(24.0)</b>	<b>137</b>

The Company reviewed its investments at September 30, 2016, and determined that no additional other-than-temporary impairment existed in the gross unrealized holding losses other than those listed in the table below. The following table sets forth the realized losses related to other-than-temporary impairments on the Company's investment portfolio recognized for the three and nine months ended September 30, 2016 and 2015:

	Three months ended		Nine months ended	
	September 30 2016	September 30 2015	September 30 2016	September 30 2015
Equity securities:				
Large-cap securities	\$—	\$—	\$(0.2)	\$—
Small-cap securities	(1.1)	(3.5)	(2.9)	(4.8)

Fixed maturities:	—	—	(2.3)	—
<i>Total other-than-temporary impairments</i>	<b>\$(1.1)</b>	<b>\$(3.5)</b>	<b>\$(5.4)</b>	<b>\$(4.8)</b>

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at September 30, 2016:

<i>(\$ millions)</i>	Amortized Fair	
	cost	value
Due in 1 year or less	<b>\$ 67.1</b>	<b>\$68.1</b>
Due after 1 year through 5 years	<b>564.0</b>	<b>579.4</b>
Due after 5 years through 10 years	<b>275.3</b>	<b>286.1</b>
Due after 10 years	<b>584.9</b>	<b>618.8</b>
U.S. government agencies mortgage-backed securities	<b>569.7</b>	<b>590.9</b>
<i>Total</i>	<b>\$ 2,061.0</b>	<b>\$2,143.3</b>

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

At September 30, 2016, State Auto P&C had U.S. government agencies mortgage-backed fixed maturity securities, with a carrying value of approximately \$106.5 million, that were pledged as collateral for the FHLB Loans (as defined in Note 3). In accordance with the terms of the FHLB Loans, State Auto P&C retains all rights regarding these pledged securities.

Fixed maturities with fair values of \$9.2 million and \$8.8 million were on deposit with insurance regulators as required by law at September 30, 2016 and December 31, 2015, respectively. The Company retains all rights regarding these securities.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the components of net investment income for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
Fixed maturities	\$15.4	\$16.1	\$47.0	\$46.4
Equity securities	1.3	1.4	4.3	4.7
Cash and cash equivalents, and other	1.4	1.6	4.1	4.3
<i>Investment income</i>	<b>18.1</b>	19.1	<b>55.4</b>	55.4
Investment expenses	0.5	0.4	1.3	1.5
<i>Net investment income</i>	<b>\$17.6</b>	\$18.7	<b>\$54.1</b>	\$53.9

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

Proceeds on sales of available-for-sale securities were \$252.6 million and \$260.6 million for the nine months ended September 30, 2016 and 2015, respectively.

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
Realized gains:				
Fixed maturities	\$—	\$2.9	\$2.1	\$4.4
Equity securities	9.9	11.8	20.6	21.8
Other invested assets	—	—	0.1	0.1
<i>Total realized gains</i>	<b>9.9</b>	14.7	<b>22.8</b>	26.3
Realized losses:				
Equity securities:				
Sales	—	(0.4 )	(0.8 )	(1.1 )
OTTI	(1.1 )	(3.5 )	(3.1 )	(4.8 )
Fixed maturities:				
OTTI	—	—	(2.3 )	—
<i>Total realized losses</i>	<b>(1.1 )</b>	(3.9 )	<b>(6.2 )</b>	(5.9 )
<i>Net realized gains on investments</i>	<b>\$8.8</b>	\$10.8	<b>\$16.6</b>	\$20.4
Change in unrealized holding (losses) gains, net of tax:				
Fixed maturities	\$(11.2)	\$8.7	\$54.5	\$(19.9)
Equity securities	4.2	(35.5 )	6.0	(43.0 )
Other invested assets	4.5	(8.5 )	4.4	(3.6 )
Deferred federal income tax liability	0.8	12.4	(22.8 )	23.3
<i>Change in net unrealized holding (losses) gains, net of tax</i>	<b>\$(1.7 )</b>	\$(22.9)	<b>\$42.1</b>	\$(43.2)



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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**3. Fair Value of Financial Instruments**

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

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

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

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

The Company utilizes one nationally recognized pricing service to estimate the majority of its available-for-sale investment portfolio's fair value. The Company obtains one price per security and the processes and control procedures employed by the Company are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company gains an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, the Company compares to other fair value pricing information gathered from other independent pricing sources. At September 30, 2016 and December 31, 2015, the Company did not adjust any of the prices received from the pricing service.

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

Transfers in and out of level categorizations are reported as having occurred at the beginning of the quarter in which the transfer occurred. There were no transfers between level categorizations during the three and nine months ended September 30, 2016 and 2015.

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

*Fixed Maturities*

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

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





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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

*Equities*

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

*Other Invested Assets*

Included in other invested assets are two international funds (“the funds”) that invest in equity securities of foreign issuers and are managed by third party investment managers. The funds had a fair value of \$80.7 million and \$77.0 million at September 30, 2016 and December 31, 2015, 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. In accordance with Accounting Standard Codification 820-10, these investments that are measured at fair value using the net asset value per share practical expedient have not been classified in the fair value hierarchy. Fair values presented here are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the condensed consolidated balance sheets.

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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The following tables set forth the Company's available-for-sale investments within the fair value hierarchy at September 30, 2016 and December 31, 2015:

<i>(\$ millions)</i>	Total	Level 1	Level 2	Level 3
<b>September 30, 2016</b>				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	<b>\$330.9</b>	<b>\$—</b>	<b>\$330.9</b>	<b>\$—</b>
Obligations of states and political subdivisions	<b>698.6</b>	<b>—</b>	<b>698.6</b>	<b>—</b>
Corporate securities	<b>522.9</b>	<b>—</b>	<b>519.4</b>	<b>3.5</b>
U.S. government agencies mortgage-backed securities	<b>590.9</b>	<b>—</b>	<b>590.9</b>	<b>—</b>
<i>Total fixed maturities</i>	<b>2,143.3</b>	<b>—</b>	<b>2,139.8</b>	<b>3.5</b>
Equity securities:				
Large-cap securities	<b>225.6</b>	<b>225.6</b>	<b>—</b>	<b>—</b>
Small-cap securities	<b>71.9</b>	<b>71.9</b>	<b>—</b>	<b>—</b>
<i>Total equity securities</i>	<b>297.5</b>	<b>297.5</b>	<b>—</b>	<b>—</b>
Other invested assets	<b>9.0</b>	<b>9.0</b>	<b>—</b>	<b>—</b>
<i>Total available-for-sale investments</i>	<b>\$2,449.8</b>	<b>\$306.5</b>	<b>\$2,139.8</b>	<b>\$3.5</b>

<i>(\$ millions)</i>	Total	Level 1	Level 2	Level 3
<b>December 31, 2015</b>				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$224.4	\$—	\$224.4	\$—
Obligations of states and political subdivisions	824.8	—	824.8	—
Corporate securities	494.4	—	491.1	3.3
U.S. government agencies mortgage-backed securities	457.1	—	457.1	—
<i>Total fixed maturities</i>	<b>2,000.7</b>	<b>—</b>	<b>1,997.4</b>	<b>3.3</b>
Equity securities:				
Large-cap securities	241.0	241.0	—	—
Small-cap securities	69.6	69.6	—	—
<i>Total equity securities</i>	<b>310.6</b>	<b>310.6</b>	<b>—</b>	<b>—</b>
Other invested assets	8.1	8.1	—	—
<i>Total available-for-sale investments</i>	<b>\$2,319.4</b>	<b>\$318.7</b>	<b>\$1,997.4</b>	<b>\$3.3</b>

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), the following tables set forth a reconciliation of the beginning and ending balances for the three and nine months ended September 30, 2016 and the year ended December 31, 2015, separately for each major category of assets:

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2016	<b>\$ 3.3</b>
Total realized gains – included in earnings	—
Total unrealized losses – included in other comprehensive income	—
Purchases	<b>0.1</b>
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at March 31, 2016	<b>\$ 3.4</b>
Total realized gains – included in earnings	—
Total unrealized losses – included in other comprehensive income	—
Purchases	—
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at June 30, 2016	<b>\$ 3.4</b>
Total realized gains – included in earnings	—
Total unrealized gains – included in other comprehensive income	—
Purchases	<b>0.1</b>
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at September 30, 2016	<b>\$ 3.5</b>
<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2015	<b>\$ 9.4</b>
Total realized gains – included in earnings	—
Total unrealized gains – included in other comprehensive income	(0.2 )
Purchases	—
Sales	(5.9 )
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at December 31, 2015	<b>\$ 3.3</b>

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

**Financial Instruments Disclosed, But Not Carried, At Fair Value***Other Invested Assets*

Included in other invested assets are common stock of the Federal Home Loan Bank of Cincinnati (the "FHLB") and the Trust Securities. The Trust Securities and FHLB common stock are carried at cost, which approximates fair value. The fair value of the FHLB common stock at September 30, 2016 was \$4.9 million and the fair value of the Trust Securities was \$0.5 million. The investments have been placed in Level 3 of the fair value hierarchy.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*Notes Receivable from Affiliate*

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

(\$ millions, except interest rates)

	September 30, 2016			December 31, 2015		
	Carrying	Fair	Interest	Carrying	Fair	Interest
	value	value	rate	value	value	rate
Notes receivable from affiliate	\$70.0	\$76.2	7.00 %	\$70.0	\$74.1	7.00 %

*Notes Payable*

Included in notes payable are the FHLB Loans, consisting of the 2013 FHLB Loan and the 2016 FHLB Loan (as defined in Note 5), and Subordinated Debentures. The Company estimates the fair value of the FHLB Loans by discounting cash flows using a borrowing rate currently available to the Company for loans with similar terms. The FHLB Loans have been placed in Level 3 of the fair value hierarchy. The carrying amount of the Subordinated Debentures approximates its fair value as the interest rate adjusts quarterly and has been disclosed in Level 3.

(\$ millions, except interest rates)

	September 30, 2016			December 31, 2015		
	Carrying	Fair	Interest	Carrying	Fair	Interest
	value	Value	rate	value	value	rate
FHLB Loan due 2021: issued \$21.5, September 2016 with fixed interest	\$21.5	\$21.6	1.73 %	\$—	\$—	— %
FHLB Loan due 2033: issued \$85.0, July 2013 with fixed interest	85.4	85.5	5.03 %	85.3	85.5	5.03 %
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.2	15.2	5.04 %	15.2	15.2	4.61 %
<i>Total notes payable</i>	<b>\$122.1</b>	<b>\$122.3</b>		\$100.5	\$100.7	

**4. Reinsurance**

The insurance subsidiaries of State Auto Financial, including State Auto P&C, Milbank and SA Ohio (collectively referred to as the “STFC Pooled Companies”) participate in a quota share reinsurance pooling arrangement (“the Pooling Arrangement”) with State Auto Mutual and its subsidiaries and affiliates (collectively referred to as the “Mutual Pooled Companies”).

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The following table sets forth a summary of the Company's external reinsurance transactions, as well as reinsurance transactions with State Auto Mutual under the Pooling Arrangement, for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
<b>Premiums earned:</b>				
Assumed from external insurers and reinsurers	<b>\$1.2</b>	\$1.1	<b>\$3.6</b>	\$3.2
Assumed under Pooling Arrangement	<b>325.8</b>	319.7	<b>968.1</b>	946.5
Ceded to external insurers and reinsurers	<b>(6.0 )</b>	(8.7 )	<b>(19.3 )</b>	(26.1 )
Ceded under Pooling Arrangement	<b>(204.4 )</b>	(207.5 )	<b>(615.7 )</b>	(626.0 )
<i>Net assumed premiums earned</i>	<b>\$116.6</b>	\$104.6	<b>\$336.7</b>	\$297.6
<b>Losses and loss expenses incurred:</b>				
Assumed from external insurers and reinsurers	<b>\$0.9</b>	\$0.8	<b>\$2.8</b>	\$2.2
Assumed under Pooling Arrangement	<b>232.8</b>	207.8	<b>721.5</b>	628.1
Ceded to external insurers and reinsurers	<b>0.3</b>	(1.2 )	<b>(2.1 )</b>	(3.6 )
Ceded under Pooling Arrangement	<b>(131.9 )</b>	(140.4 )	<b>(440.1 )</b>	(427.2 )
<i>Net assumed losses and loss expenses incurred</i>	<b>\$102.1</b>	\$67.0	<b>\$282.1</b>	\$199.5

**5. Notes Payable***FHLB Loan*

State Auto Financial's subsidiary, State Auto P&C, is a member of the FHLB, and in September 2016 entered into a new term loan with the FHLB in the principal amount of \$21.5 million (the "2016 FHLB Loan"). The 2016 FHLB Loan is a five-year term loan and may be called (prepaid) after three years with no prepayment penalty. The 2016 FHLB Loan provides for interest-only payments during its term, with principal due in full at maturity. The interest rate is fixed over the term of the loan at 1.73%. The 2016 FHLB Loan is fully secured by a pledge of specific investment securities of State Auto P&C.

**6. Income Taxes**

The following table sets forth the reconciliation between actual federal income tax expense and the amount computed at the indicated statutory rate for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Three months ended September 30				Nine months ended September 30			
	2016	2015	2016	2015	2016	2015	2016	2015
Amount at statutory rate	<b>\$2.6</b>	<b>35.0 %</b>	\$10.5	35.0 %	<b>\$(4.8)</b>	<b>35.0 %</b>	\$23.3	35.0 %
Tax-exempt interest and dividends received deduction	<b>(1.6 )</b>	<b>(22.6 )</b>	(2.1 )	(7.0 )	<b>(5.5 )</b>	<b>40.0</b>	(6.6 )	(9.9 )
Other, net	<b>(3.7 )</b>	<b>(48.6 )</b>	0.8	2.8	<b>7.9</b>	<b>(58.0)</b>	1.7	2.6
<i>Federal income tax (benefit) expense and effective rate</i>	<b>\$(2.7)</b>	<b>(36.2)%</b>	\$9.2	30.8 %	<b>\$(2.4)</b>	<b>17.0 %</b>	\$18.4	27.7 %

Income taxes for the nine months ended September 30, 2016 reflect the impact of a correction of prior period deferred tax expense related to expired stock options. As a result of the correction, deferred federal income tax expense and

additional paid-in-capital were reduced by \$1.6 million, respectively.

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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)

**7. Pension and Postretirement Benefit Plans**

The following table sets forth the components of net periodic cost for the Company's pension and postretirement benefit plans for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Pension		Postretirement		Pension		Postretirement	
	Three months ended				Nine months ended			
	September 30				September 30			
	<b>2016</b>	2015	<b>2016</b>	2015	<b>2016</b>	2015	<b>2016</b>	2015
Service cost	<b>\$1.6</b>	\$2.0	\$—	\$—	<b>\$4.7</b>	\$5.9	\$—	\$—
Interest cost	<b>3.0</b>	2.8	<b>0.2</b>	0.3	<b>8.9</b>	8.5	<b>0.6</b>	0.7
Expected return on plan assets	<b>(3.9)</b>	(3.5)	—	—	<b>(11.3)</b>	(10.4)	—	—
Amortization of:								
Negative prior service cost	—	—	<b>(1.3)</b>	(1.3)	—	—	<b>(4.1)</b>	(4.1)
Net actuarial loss	<b>2.3</b>	2.7	<b>0.1</b>	0.1	<b>6.9</b>	8.2	<b>0.2</b>	0.4
<i>Net periodic cost (benefit)</i>	<b>\$3.0</b>	\$4.0	<b>\$(1.0)</b>	\$(0.9)	<b>\$9.2</b>	\$12.2	<b>\$(3.3)</b>	\$(3.0)

The Company contributed \$34.5 million to its pension plan for the nine months ended September 30, 2016.



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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)

**8. Other Comprehensive Income and Accumulated Other Comprehensive Income**

The following table sets forth the changes in the Company's accumulated other comprehensive income component (AOCI), net of tax, for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)

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

Beginning  
balance

at \$ 112.3      \$(29.6 ) \$82.7

July  
1,  
2016

Other  
comprehensive  
income  
before  
reclassifications

Amounts  
reclassified  
from AOCI  
(a) \$ 5.7      ) 0.7      (5.0 )

Net  
current  
period  
other  
comprehensive  
(loss)  
income

Ending  
balance

at \$ 110.6      \$(28.9 ) \$81.7

September  
30,  
2016

Beginning  
balance

at \$ 89.7      \$(36.3 ) \$53.4

July  
1,  
2015

Other comprehensive loss before reclassifications	(15.8 )	—	(15.8 )
Amounts reclassified from AOCI	(7.1 )	0.9	(6.2 )
Net current period other comprehensive income	(22.9 )	0.9	(22.0 )
Ending balance at September 30, 2015	\$ 66.8	\$(35.4 )	\$31.4

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

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Total
---------------	--------------------------------------------------------------	--------------------	-------

Beginning balance at January 1, 2016	\$ 68.5	\$(30.9 )	\$37.6
--------------------------------------	---------	-----------	--------

Other comprehensive income before reclassifications	52.9	—	52.9
Amounts reclassified from AOCI	(10.8 )	2.0	(8.8 )
Net current period other	42.1	2.0	44.1

comprehensive  
income  
*Ending  
balance*  
*at \$ 110.6      \$ (28.9 ) \$ 81.7*  
*September*  
*30,*  
*2016*

Beginning  
balance  
*at \$ 110.0      \$ (38.3 ) \$ 71.7*  
*January*  
*1,*  
*2015*

Other  
comprehensive  
loss ~~29.9~~ ) —      (29.9 )  
before  
reclassifications

Amounts  
reclassified  
from ~~13.3~~ ) 2.9      (10.4 )

AOCI  
(a)

Net  
current  
period  
other ~~43.2~~ ) 2.9      (40.3 )

comprehensive  
(loss)  
income  
*Ending  
balance*

*at \$ 66.8      \$ (35.4 ) \$ 31.4*  
*September*  
*30,*  
*2015*

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the reclassifications out of accumulated other comprehensive income, by component, to the Company's condensed consolidated statement of income for the three and nine months ended September 30, 2016 and 2015:

(\$  
millions)

Three months ended September 30	2016	2015	Details about Accumulated Other Comprehensive Income Components
Unrealized gains on available securities	8.8	10.8	Realized gain on sale of securities
	(3.1 )	(3.7 )	Tax expense
	5.7	7.1	Net of tax
Amortization of benefit plan items			
Negative prior service cost	1.3	1.3	(b)
Net actuarial loss	(2.1 )	(2.8 )	(b)
	(1.1 )	(1.5 )	Total before tax
	0.4	0.6	Tax benefit
	(0.7 )	(0.9 )	Net of tax
<i>Total reclassifications for the period</i>	<b>\$5.0</b>	<b>\$6.2</b>	

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

(\$  
millions)

Nine months ended		September 30		2016		2015	
Details about Accumulated Other Comprehensive Income Components							
Affected line item in the Condensed Consolidated Statements of Income							
Unrealized gains on available for sale securities							
	\$16.6	\$20.4		Realized gain on sale of securities			
	<b>16.6</b>	20.4		Total before tax			
	<b>(5.8)</b>	(7.1)		Tax expense			
	<b>10.8</b>	13.3		Net of tax			
Amortization of benefit plan items							
Negative prior service cost							
	<b>4.1</b>	4.1		(b)			
Net actuarial loss							
	<b>(7.1)</b>	(8.6)		(b)			
	<b>(3.0)</b>	(4.5)		Total before tax			
	<b>1.0</b>	1.6		Tax benefit			
	<b>(2.0)</b>	2.9		Net of tax			
<i>Total reclassifications for the period</i>							
	<b>\$8.8</b>	\$10.4					

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

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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)

**9. Net Earnings (Loss) per Common Share**

The following table sets forth the compilation of basic and diluted earnings per common share for the three and nine months ended September 30, 2016 and 2015:

	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
<i>(\$ and shares in millions, except per share amounts)</i>				
Numerator:				
Net income (loss) for basic earnings (loss) per common share	<b>\$10.1</b>	\$20.7	<b>\$(11.5)</b>	\$48.1
Denominator:				
Weighted average shares for basic net earnings (loss) per common share	<b>41.6</b>	41.1	<b>41.5</b>	41.1
Effect of dilutive share-based awards	<b>0.5</b>	0.8	—	0.4
<i>Adjusted weighted average shares for diluted net earnings (loss) per common share</i>	<b>42.1</b>	41.9	<b>41.5</b>	41.5
Basic net earnings (loss) per common share	<b>\$0.24</b>	\$0.50	<b>\$(0.28)</b>	\$1.17
Diluted net earnings (loss) per common share	<b>\$0.24</b>	\$0.50	<b>\$(0.28)</b>	\$1.16

The following table sets forth common stock options and restricted share units ("RSU award") provided to each outside director of the Company that were not included in the computation of diluted earnings per common share because the exercise price of the options, or awards, was greater than the average market price or their inclusion would have been antidilutive for the three and nine months ended September 30, 2016 and 2015.

	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
<i>(shares in millions)</i>				
Total number of antidilutive options and awards	<b>1.1</b>	1.1	<b>1.4</b>	1.7

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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)

**10. Segment Information**

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

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

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

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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 sets forth financial information regarding the Company's reportable segments for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
Revenue from external sources:				
Insurance segments				
Personal insurance	\$145.5	\$147.2	\$436.3	\$445.4
Business insurance	115.0	119.2	353.8	355.3
Specialty insurance	65.3	53.3	178.0	145.8
<i>Total insurance segments</i>	<b>325.8</b>	319.7	<b>968.1</b>	946.5
Investment operations segment				
Net investment income	17.6	18.7	54.1	53.9
Net realized capital gains	8.8	10.8	16.6	20.4
<i>Total investment operations segment</i>	<b>26.4</b>	29.5	<b>70.7</b>	74.3
All other	0.6	0.5	1.7	1.2
<i>Total revenue from external sources</i>	<b>352.8</b>	349.7	<b>1,040.5</b>	1,022.0
Intersegment revenue	1.5	1.4	4.4	4.2
<i>Total revenue</i>	<b>354.3</b>	351.1	<b>1,044.9</b>	1,026.2
Reconciling items:				
Eliminate intersegment revenues	(1.5 )	(1.4 )	(4.4 )	(4.2 )
<i>Total consolidated revenues</i>	<b>\$352.8</b>	\$349.7	<b>\$1,040.5</b>	\$1,022.0
Segment income before federal income tax:				
Insurance segments SAP underwriting income (loss)				
Personal insurance	\$2.6	\$6.9	\$(18.6 )	\$14.1
Business insurance	(17.5 )	(6.2 )	(36.8 )	(19.3 )
Specialty insurance	(4.1 )	0.6	(28.3 )	(4.3 )
<i>Total insurance segments</i>	<b>(19.0 )</b>	1.3	<b>(83.7 )</b>	(9.5 )
Investment operations segment				
Net investment income	17.6	18.7	54.1	53.9
Net realized capital gains	8.8	10.8	16.6	20.4
<i>Total investment operations segment</i>	<b>26.4</b>	29.5	<b>70.7</b>	74.3
All other	0.1	0.1	0.3	(0.2 )
<i>Total segment income (loss) before tax expense</i>	<b>7.5</b>	30.9	<b>(12.7 )</b>	64.6
Reconciling items:				
GAAP expense adjustments	2.4	0.9	5.8	8.6
Interest expense on corporate debt	(1.4 )	(1.3 )	(4.1 )	(4.0 )
Corporate expenses	(1.1 )	(0.6 )	(2.9 )	(2.7 )
<i>Total reconciling items</i>	<b>(0.1 )</b>	(1.0 )	<b>(1.2 )</b>	1.9
<i>Total consolidated income (loss) before federal income tax expense</i>	<b>\$7.4</b>	\$29.9	<b>\$(13.9 )</b>	\$66.5

Investable assets attributable to the Company's investment operations segment totaled \$2,675.4 million and \$2,529.8 million at September 30, 2016 and December 31, 2015, respectively.





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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)

**11. Contingencies and Litigation**

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

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

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

The term “third quarter” as used below refers to the three months ended September 30, for the time period then ended.

For a glossary of terms for State Auto Financial Corporation and its subsidiaries and affiliates and a glossary of selected insurance and accounting terms, see the section entitled “Important Defined Terms Used in this Form 10-K” included in our Annual Report on Form 10-K for the year ended December 31, 2015 (the “2015 Form 10-K”).

The discussion and analysis presented below relates to the material changes in financial condition and results of operations for our consolidated balance sheets as of September 30, 2016 and December 31, 2015, and for the consolidated statements of income for the three and nine month periods ended September 30, 2016 and 2015. This discussion and analysis should be read together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in the 2015 Form 10-K, and in particular the discussions in those sections thereof entitled “Overview,” “Executive Summary” and “Critical Accounting Policies.” Readers are encouraged to review the entire 2015 Form 10-K, as it includes information regarding our Company not discussed in this Form 10-Q. This information will assist in your understanding of the discussion of our current period financial results.

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

Forward-looking statements speak only as of the date the statements were made available. Although we believe that the expectations reflected in forward-looking statements have a reasonable basis, we can give no assurance that these expectations will prove to be correct. Forward-looking statements are subject to risks and uncertainties that could cause actual events or results to differ materially from those expressed in or implied by the statements. For a discussion of the most significant risks and uncertainties that could cause our actual results to differ materially from those projected, see “Risk Factors” in Item 1A of the 2015 Form 10-K, updated by Part II, Item 1A of this Form 10-Q. Except to the limited extent required by applicable law, we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The Company has four reportable segments: personal insurance, business insurance, specialty insurance and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied, general liability, and workers' compensation insurance covering small-to-medium sized commercial exposures. The specialty insurance segment provides commercial coverages that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. The investment operations segment, managed by Stateco, provides investment services. See “Personal and Business Insurance” and “Specialty Insurance” in Item 1 of the 2015 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2016 is set forth in Note 10 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

**POOLING ARRANGEMENT**

The STFC Pooled Companies and the Mutual Pooled Companies participate in a quota share reinsurance pooling arrangement referred to as the “Pooling Arrangement.” Under the Pooling Arrangement, State Auto Mutual assumes premiums, losses and expenses from each of the Pooled Companies and in turn cedes to each of the Pooled Companies a specified portion of premiums, losses and expenses based on each of the Pooled Companies’ respective

pooling percentages. State Auto Mutual then retains the balance of the pooled business.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

**STFC**

**Pooled**

**Companies:**

State

Auto 1.0 %

P&C

Millbrook

SA

Ohio

Total

STFC 65.0 %

Pooled

Companies

**State**

**Auto**

**Mutual**

**Pooled**

**Companies:**

State

Auto 4.5 %

Mutual

SA

Wisconsin

Meridian

Security

Patrons

Mutual 0.5

RIC

Plaza

American

Compensation

Bloomington

Compensation

Total

State

Auto 35.0 %

Mutual

Pooled

Companies

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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**RESULTS OF OPERATIONS**

Our pre-tax income for the three months ended September 30, 2016 was \$7.4 million and pre-tax loss for the nine months ended September 30, 2016 was \$13.9 million compared to pre-tax income of \$29.9 million and \$66.5 million, respectively, for the same 2015 periods. The quarter and year to date decreases were primarily due to an increase in losses, both catastrophe and non-catastrophe, when compared to the same 2015 periods. For the three and nine months ended September 30, 2016, we reported net realized gains on investments of \$8.8 million and \$16.6 million, respectively, compared to \$10.8 million and \$20.4 million, respectively, for the same 2015 periods.

The following table sets forth certain key performance indicators we use to monitor our operations for the three and nine months ended September 30, 2016 and 2015:

	Three months ended		Nine months ended	
	September 30	September 30	September 30	September 30
	2016	2015	2016	2015
<i>(\$ millions, except per share amounts)</i>				
<u>GAAP Basis:</u>				
Total revenues	\$352.8	\$349.7	\$1,040.5	\$1,022.0
Income (loss) before federal income taxes	\$7.4	\$29.9	\$(13.9)	\$66.5
Net income (loss)	\$10.1	\$20.7	\$(11.5)	\$48.1
Basic earnings (loss) per share	\$0.24	\$0.50	\$(0.28)	\$1.17
Diluted earnings (loss) per share	\$0.24	\$0.50	\$(0.28)	\$1.16
Stockholders' equity	\$907.8	\$875.3		
Return on average equity (LTM)	(0.9)%	13.3%		
Book value per share	\$21.82	\$21.28		
Debt to capital ratio	11.9%	10.3%		
Cat loss and ALAE ratio	2.5%	2.1%	6.8%	4.9%
Non-cat loss and LAE ratio	68.8%	62.8%	67.6%	61.4%
Loss and LAE ratio	71.3%	64.9%	74.4%	66.3%
Expense ratio	33.7%	34.2%	33.5%	33.7%
Combined ratio	105.0%	99.1%	107.9%	100.0%
Premium written growth	3.5%	17.1%	1.6%	15.9%
Investment yield	2.9%	3.2%	3.0%	3.2%
<u>SAP Basis:</u>				
Cat loss and ALAE ratio	2.5%	2.1%	6.8%	4.9%
Non-cat loss and ALAE ratio	63.7%	56.8%	61.7%	55.1%
ULAE ratio	5.3%	6.1%	6.0%	6.4%
Loss and LAE ratio	71.5%	65.0%	74.5%	66.4%
Expense ratio	33.4%	34.1%	33.5%	33.8%
Combined ratio	104.9%	99.1%	108.0%	100.2%

	Twelve months ended	
	September 30	September 30
	2016	2015
<i>(\$ millions)</i>		
Net premiums written to surplus	1.6	1.7



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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

**Insurance Segments**

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

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

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred acquisition costs, see “Critical Accounting Policies – Deferred Acquisition Costs” section included in Item 7 of our 2015 Form 10-K.

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

The following tables set forth our insurance segments’ SAP underwriting gain (loss) and SAP combined ratios for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)

	<b>Three months ended September 30, 2016</b>							
	<b>Personal</b>	<b>% Ratio</b>	<b>Business</b>	<b>% Ratio</b>	<b>Specialty</b>	<b>% Ratio</b>	<b>Total</b>	<b>% Ratio</b>
Net written premiums	<b>\$154.6</b>		<b>\$ 114.5</b>		<b>\$ 66.7</b>		<b>\$335.8</b>	
Earned premiums	<b>145.5</b>		<b>115.0</b>		<b>65.3</b>		<b>325.8</b>	
Cat loss and ALAE	<b>4.7</b>	<b>3.2</b>	<b>3.3</b>	<b>2.9</b>	<b>0.1</b>	<b>0.2</b>	<b>8.1</b>	<b>2.5</b>
Non-cat loss and ALAE	<b>89.5</b>	<b>61.6</b>	<b>76.8</b>	<b>66.8</b>	<b>41.3</b>	<b>63.2</b>	<b>207.6</b>	<b>63.7</b>
ULAE	<b>7.5</b>	<b>5.1</b>	<b>7.0</b>	<b>6.1</b>	<b>2.5</b>	<b>3.9</b>	<b>17.0</b>	<b>5.3</b>
Underwriting expenses	<b>41.2</b>	<b>26.6</b>	<b>45.4</b>	<b>39.7</b>	<b>25.5</b>	<b>38.3</b>	<b>112.1</b>	<b>33.4</b>
<i>SAP underwriting gain (loss) and SAP combined ratio</i>	<b>\$2.6</b>	<b>96.5</b>	<b>\$(17.5)</b>	<b>115.5</b>	<b>\$(4.1)</b>	<b>105.6</b>	<b>\$(19.0)</b>	<b>104.9</b>

(\$ millions)

	<b>Three months ended September 30, 2015</b>							
	<b>Personal</b>	<b>% Ratio</b>	<b>Business</b>	<b>% Ratio</b>	<b>Specialty</b>	<b>% Ratio</b>	<b>Total</b>	<b>% Ratio</b>
Net written premiums	<b>\$152.4</b>		<b>\$ 122.1</b>		<b>\$ 50.0</b>		<b>\$324.5</b>	
Earned premiums	<b>147.2</b>		<b>119.2</b>		<b>53.3</b>		<b>\$319.7</b>	
Cat loss and ALAE	<b>5.7</b>	<b>3.9</b>	<b>1.1</b>	<b>0.9</b>	<b>—</b>	<b>0.1</b>	<b>6.8</b>	<b>2.1</b>
Non-cat loss and ALAE	<b>78.7</b>	<b>53.5</b>	<b>70.5</b>	<b>59.1</b>	<b>32.2</b>	<b>60.2</b>	<b>181.4</b>	<b>56.8</b>
ULAE	<b>10.7</b>	<b>7.2</b>	<b>7.1</b>	<b>6.0</b>	<b>1.8</b>	<b>3.4</b>	<b>19.6</b>	<b>6.1</b>
Underwriting expenses	<b>45.2</b>	<b>29.7</b>	<b>46.7</b>	<b>38.2</b>	<b>18.7</b>	<b>37.4</b>	<b>110.6</b>	<b>34.1</b>



*SAP underwriting gain (loss)* \$6.9 94.3 \$(6.2 ) 104.2 \$ 0.6 101.1 \$1.3 99.1  
*and SAP combined ratio*

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

(\$ millions)	Nine months ended September 30, 2016							
	Personal	% Ratio	Business	% Ratio	Specialty	% Ratio	Total	% Ratio
Net written premiums	\$444.8		\$ 345.2		\$ 196.2		\$986.2	
Earned premiums	436.3		353.8		178.0		968.1	
Cat loss and ALAE	47.2	10.8	17.6	5.0	0.6	0.3	65.4	6.8
Non-cat loss and ALAE	252.9	58.0	219.0	61.9	125.9	70.7	597.8	61.7
ULAE	27.2	6.2	22.8	6.4	8.3	4.7	58.3	6.0
Underwriting expenses	127.6	28.7	131.2	38.0	71.5	36.4	330.3	33.5
<i>SAP underwriting loss and SAP combined ratio</i>	<b>\$(18.6)</b>	<b>103.7</b>	<b>\$(36.8)</b>	<b>111.3</b>	<b>\$(28.3)</b>	<b>112.1</b>	<b>\$(83.7)</b>	<b>108.0</b>

(\$ millions)	Nine months ended September 30, 2015							
	Personal	% Ratio	Business	% Ratio	Specialty	% Ratio	Total	% Ratio
Net written premiums	\$445.4		\$ 368.5		\$ 156.9		\$970.8	
Earned premiums	445.4		355.3		145.8		946.5	
Cat loss and ALAE	33.2	7.5	13.4	3.8	0.2	0.1	46.8	4.9
Non-cat loss and ALAE	233.8	52.5	204.2	57.4	83.3	57.2	521.3	55.1
ULAE	34.7	7.7	19.5	5.5	5.8	4.1	60.0	6.4
Underwriting expenses	129.6	29.1	137.5	37.3	60.8	38.8	327.9	33.8
<i>SAP underwriting gain (loss) and SAP combined ratio</i>	<b>\$14.1</b>	<b>96.8</b>	<b>\$(19.3)</b>	<b>104.0</b>	<b>\$(4.3)</b>	<b>100.2</b>	<b>\$(9.5)</b>	<b>100.2</b>

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

*Personal Insurance Segment*

The following table sets forth the net written premiums by major product line of business for our personal insurance segment for the three and nine months ended September 30, 2016 and 2015:

Table 1

(\$ millions)

	Net Written Premiums					
	Three months ended September 30			Nine months ended September 30		
	2016	2015	% Change	2016	2015	% Change
Personal insurance segment:						
Personal auto	\$86.9	\$85.4	1.8	\$253.1	\$254.1	(0.4 )
Homeowners	59.3	59.3	—	165.5	166.6	(0.7 )
Other personal	8.4	7.7	9.1	26.2	24.7	6.1
<i>Total personal</i>	<b>\$154.6</b>	\$152.4	1.4	<b>\$444.8</b>	\$445.4	(0.1 )

The following tables set forth the SAP loss and ALAE ratios by major product line of business for our personal insurance segment with the catastrophe and non-catastrophe impact shown separately for the three and nine months ended September 30, 2016 and 2015:

Table 2

**Statutory Loss and LAE Ratios**

(\$ millions)

%

Three months ended September 30	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	Total Loss and LAE Ratio
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**2016**Personal insurance segment:

Personal auto	\$82.6	\$ 1.5	\$62.9	\$64.4	1.8	76.2	78.0
Homeowners	54.3	2.0	22.7	24.7	3.8	41.6	45.4
Other personal	8.6	1.2	3.9	5.1	13.6	45.9	59.5
<i>Total personal</i>	<b>145.5</b>	<b>4.7</b>	<b>89.5</b>	<b>94.2</b>	<b>3.2</b>	<b>61.6</b>	<b>64.8</b>
ULAE	—	—	—	7.5	—	—	5.1
<i>Total Loss and LAE</i>	<b>\$145.5</b>	<b>\$ 4.7</b>	<b>\$89.5</b>	<b>\$101.7</b>	<b>3.2</b>	<b>61.6</b>	<b>69.9</b>

## 2015

Personal insurance segment:

Personal auto	\$84.2	\$ 0.7	\$55.2	\$55.9	0.9	65.5	66.4
Homeowners	55.0	4.5	19.4	23.9	8.3	35.3	43.6
Other personal	8.0	0.5	4.1	4.6	5.4	52.1	57.5
<i>Total personal</i>	<b>147.2</b>	<b>5.7</b>	<b>78.7</b>	<b>84.4</b>	<b>3.9</b>	<b>53.5</b>	<b>57.4</b>
ULAE	—	—	—	10.7	—	—	7.2
<i>Total Loss and LAE</i>	<b>\$147.2</b>	<b>\$ 5.7</b>	<b>\$78.7</b>	<b>\$95.1</b>	<b>3.9</b>	<b>53.5</b>	<b>64.6</b>

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Table 3

Statutory Loss and LAE Ratios	(\$ millions)		%				Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	

**2016**Personal insurance segment:

Personal auto	\$247.3	\$ 7.1	\$180.7	\$187.8	22.9	73.0	75.9
Homeowners	163.8	36.4	65.2	101.6	22.2	39.8	62.0
Other personal	25.2	3.7	7.0	10.7	14.6	28.0	42.6
<i>Total personal</i>	<b>436.3</b>	<b>47.2</b>	<b>252.9</b>	<b>300.1</b>	<b>10.8</b>	<b>58.0</b>	<b>68.8</b>
ULAE	—	—	—	27.2	—	—	6.2
<i>Total Loss and LAE</i>	<b>\$436.3</b>	<b>\$ 47.2</b>	<b>\$252.9</b>	<b>\$327.3</b>	<b>10.8</b>	<b>58.0</b>	<b>75.0</b>

## 2015

Personal insurance segment:

Personal auto	\$255.2	\$ 4.4	\$166.7	\$171.1	11.7	65.3	67.0
Homeowners	166.1	26.9	59.5	86.4	16.2	35.8	52.0
Other personal	24.1	1.9	7.6	9.5	7.8	31.8	39.6
<i>Total personal</i>	<b>445.4</b>	<b>33.2</b>	<b>233.8</b>	<b>267.0</b>	<b>7.5</b>	<b>52.5</b>	<b>60.0</b>
ULAE	—	—	—	34.7	—	—	7.7
<i>Total Loss and LAE</i>	<b>\$445.4</b>	<b>\$ 33.2</b>	<b>\$233.8</b>	<b>\$301.7</b>	<b>7.5</b>	<b>52.5</b>	<b>67.7</b>

The personal insurance segment's net written premiums for the three months ended September 30, 2016 increased 1.4% and were flat year to date when compared to the same 2015 periods (Table 1). While total policies in force continued to decline in the first nine months of 2016, new business policy counts were up, and personal auto and homeowners new business premiums increased in the first nine months of 2016 when compared to the same 2015 period. During the first half of 2016, we increased the number of personal lines agency appointments and conducted pricing reviews designed to improve personal lines production.

The personal insurance segment's SAP catastrophe loss ratios for the three and nine months ended September 30, 2016 were 3.2% and 10.8%, respectively, compared to 3.9% and 7.5%, respectively, for the same 2015 periods (Tables 2 - 3). Year to date, weather events classified as catastrophes have generally been more severe than those experienced in 2015. During the second quarter of 2016 we were impacted by storms in Texas, primarily wind and hail, which accounted for slightly less than half of the personal insurance segment's catastrophe losses for the nine months ended September 30, 2016.

The personal insurance segment's SAP non-catastrophe loss and ALAE ratios for the three and nine months ended September 30, 2016 were 61.6% and 58.0%, respectively, compared to 53.5% and 52.5%, respectively, for the same 2015 periods (Tables 2 - 3). The SAP non-catastrophe loss and ALAE ratios for the three and nine months ended September 30, 2016 increased 8.1 points and 5.5 points, respectively, when compared to the same 2015 periods (Tables 2 - 3) primarily due to personal auto. Personal auto results for the quarter and year were impacted by an increased level of bodily injury severity trends which resulted in increases in ultimate loss and ALAE estimates for prior accident years, primarily 2014 and 2015, when compared to the same 2015 periods. The personal auto current accident year loss and ALAE estimates reflect the impact of continued increased bodily injury severity trends as well as pricing and underwriting actions we have taken in the last 15 months.



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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*Business Insurance Segment*

The following table sets forth the net written premiums by major product line of business for our business insurance segment for the three and nine months ended September 30, 2016 and 2015:

Table 4

(\$ millions)

	Net Written Premiums					
	Three months ended September 30			Nine months ended September 30		
	2016	2015	% Change	2016	2015	% Change
Business insurance segment:						
Commercial auto	<b>\$20.6</b>	\$26.6	(22.6 )	<b>\$65.9</b>	\$79.5	(17.1 )
Commercial multi-peril	<b>29.5</b>	30.4	(3.0 )	<b>88.6</b>	91.4	(3.1 )
Fire & allied lines	<b>19.0</b>	19.0	—	<b>54.6</b>	56.1	(2.7 )
Other & product liability	<b>17.2</b>	17.2	—	<b>53.3</b>	57.7	(7.6 )
Workers' compensation	<b>24.0</b>	24.7	(2.8 )	<b>70.2</b>	70.8	(0.8 )
Other commercial	<b>4.2</b>	4.2	—	<b>12.6</b>	13.0	(3.1 )
<i>Total business</i>	<b>\$114.5</b>	\$122.1	(6.2 )	<b>\$345.2</b>	\$368.5	(6.3 )

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth the SAP loss and ALAE ratios by major product line of business for our business insurance segment with the catastrophe and non-catastrophe impact shown separately for the three and nine months ended September 30, 2016 and 2015:

Table 5

Statutory Loss and LAE Ratios	(\$ millions)		%				Total Loss and LAE Ratio
	Three months ended September 30	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	
<b>2016</b>							
<u>Business insurance segment:</u>							
Commercial auto	\$23.1	\$0.1	\$19.0	\$19.1	0.2	82.9	83.1
Commercial multi-peril	29.7	2.2	16.6	18.8	7.6	55.5	63.1
Fire & allied lines	18.2	0.9	13.1	14.0	4.9	72.3	77.2
Other & product liability	17.6	—	11.6	11.6	—	66.0	66.0
Workers' compensation	22.3	—	14.6	14.6	—	65.4	65.4
Other commercial	4.1	0.1	1.9	2.0	2.0	45.8	47.8
<i>Total business</i>	<b>115.0</b>	<b>3.3</b>	<b>76.8</b>	<b>80.1</b>	<b>2.9</b>	<b>66.8</b>	<b>69.7</b>
ULAE	—	—	—	7.0	—	—	6.1
<i>Total Loss and LAE</i>	<b>\$115.0</b>	<b>\$3.3</b>	<b>\$76.8</b>	<b>\$87.1</b>	<b>2.9</b>	<b>66.8</b>	<b>75.8</b>

## 2015

Business insurance segment:

Commercial auto	\$25.6	\$0.1	17.0	\$22.2	\$22.3	0.2	87.1	87.3
Commercial multi-peril	29.9	1.4	21.3	22.7	4.7	71.3	76.0	
Fire & allied lines	18.7	(0.4)	2.2	1.8	(1.8)	11.2	9.4	
Other & product liability	18.4	—	9.8	9.8	(0.1)	53.3	53.2	
Workers' compensation	22.4	—	13.6	13.6	—	60.6	60.6	
Other commercial	4.2	—	1.4	1.4	(0.3)	32.6	32.3	
<i>Total business</i>	<b>119.2</b>	<b>1.1</b>	<b>70.5</b>	<b>71.6</b>	<b>0.9</b>	<b>59.1</b>	<b>60.0</b>	
ULAE	—	—	—	7.1	—	—	6.0	
<i>Total Loss and LAE</i>	<b>\$119.2</b>	<b>\$1.1</b>	<b>\$70.5</b>	<b>\$78.7</b>	<b>0.9</b>	<b>59.1</b>	<b>66.0</b>	

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Table 6

Statutory Loss and LAE Ratios	(\$ millions)			%			Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	Non-Cat Loss & ALAE Ratio	

Nine months ended September 30

**2016**Business insurance segment:

Commercial auto	\$72.9	\$ 1.0	\$58.2	\$59.2	1.3	80.0	81.3
Commercial multi-peril	89.6	8.4	49.4	57.8	9.4	55.1	64.5
Fire & allied lines	55.2	8.1	29.1	37.2	14.6	52.9	67.5
Other & product liability	53.6	—	33.7	33.7	—	62.9	62.9
Workers' compensation	70.0	—	44.4	44.4	—	63.5	63.5
Other commercial	12.5	0.1	4.2	4.3	0.8	33.4	34.2
<i>Total business</i>	<b>353.8</b>	<b>17.6</b>	<b>219.0</b>	<b>236.6</b>	<b>5.0</b>	<b>61.9</b>	<b>66.9</b>
ULAE	—	—	—	22.8	—	—	6.4
<i>Total Loss and LAE</i>	<b>\$353.8</b>	<b>\$ 17.6</b>	<b>\$219.0</b>	<b>\$259.45.0</b>		<b>61.9</b>	<b>73.3</b>

## 2015

Business insurance segment:

Commercial auto	\$76.1	\$ 0.4	\$56.7	\$57.1	0.5	74.6	75.1
Commercial multi-peril	89.8	6.6	53.7	60.3	7.3	59.9	67.2
Fire & allied lines	56.2	6.4	20.2	26.6	11.4	35.8	47.2
Other & product liability	54.5	—	30.1	30.1	—	55.2	55.2
Workers' compensation	65.9	—	39.7	39.7	—	60.2	60.2
Other commercial	12.8	—	3.8	3.8	0.1	30.0	30.1
<i>Total business</i>	<b>355.3</b>	<b>13.4</b>	<b>204.2</b>	<b>217.6</b>	<b>3.8</b>	<b>57.4</b>	<b>61.2</b>
ULAE	—	—	—	19.5	—	—	5.5
<i>Total Loss and LAE</i>	<b>\$355.3</b>	<b>\$ 13.4</b>	<b>\$204.2</b>	<b>\$237.1</b>	<b>3.8</b>	<b>57.4</b>	<b>66.7</b>

Net written premiums for the business insurance segment for the three and nine months ended September 30, 2016 decreased 6.2% and 6.3%, respectively, when compared to the same 2015 periods (Table 4). The decrease for the quarter was due primarily to (i) our decision to exit our large account business and (ii) rate actions to improve profitability in commercial auto. In addition to these same factors, the year-to-date decrease was attributable to changes made to our regional sales teams during the first quarter of 2016, including staff reductions and reassignment of agency relationships among the remaining staff.

The business insurance segment's SAP catastrophe loss ratios for the three and nine months ended September 30, 2016 were 2.9% and 5.0%, respectively, compared to 0.9% and 3.8%, respectively, for the same 2015 periods (Tables 5 - 6). Year to date, the business insurance segment's SAP catastrophe loss ratio was impacted by the Texas storms described in the personal insurance segment discussion above.

The business insurance segment's SAP non-catastrophe loss and ALAE ratios for the three and nine months ended September 30, 2016 were 66.8% and 61.9%, respectively, compared to 59.1% and 57.4%, respectively, for the same 2015 periods (Tables 5 - 6). The SAP non-catastrophe loss and ALAE ratios for the three and nine months ended September 30, 2016 increased 7.7 points and 4.5 points, respectively, when compared to the same 2015 periods (Tables 5 - 6), primarily due to increase in fire & allied non-catastrophe losses. The fire & allied ratio increases were primarily due to two large fire losses that occurred during the third quarter 2016. For the three months ended September 30, 2016, the commercial auto ratio improved when compared to the same 2015 period (Tables 5), primarily due to less adverse development of prior accident year losses. The bodily severity trend increases we noted



beginning in the third quarter 2015 have continued through the current quarter. Year to date, the commercial auto ratio increase was attributable to increased bodily injury severity trends when compared to the same 2015 period, which resulted in increases in ultimate loss and ALAE estimates for prior accident years, primarily 2014 and 2015, as well as higher current accident year loss and ALAE estimates.

Somewhat offsetting the increases in the SAP non-catastrophe loss and ALAE ratios for the three and nine months ended September 30, 2016 were fewer and less severe losses in the commercial-multi peril line when compared to the same 2015 periods.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Commercial multi-peril results for the three and nine months ended September 30, 2016 improved primarily as a result of underwriting actions taken to improve production and profitability.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*Specialty Insurance Segment*

Certain business previously included in the programs unit has been reclassified to the E&S property unit. Prior reporting periods have been restated to conform to the new presentation.

The following table sets forth the net written premiums by unit for our specialty insurance segment for the three and nine months ended September 30, 2016 and 2015.

Table 7

(\$ millions)

	Net Written Premiums					
	Three months ended			Nine months ended		
	September 30			September 30		
Specialty insurance segment:	<b>2016</b>	2015	% Change	<b>2016</b>	2015	% Change
E&S property	<b>\$7.8</b>	\$7.0	11.4	<b>\$31.6</b>	\$36.4	(13.2 )
E&S casualty	<b>31.6</b>	19.4	62.9	<b>75.9</b>	47.4	60.1
Programs	<b>27.3</b>	23.6	15.7	<b>88.7</b>	73.1	21.3
<i>Total specialty</i>	<b>\$66.7</b>	\$50.0	33.4	<b>\$196.2</b>	\$156.9	25.0

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth SAP loss and ALAE ratios for our specialty insurance segment with the catastrophe and non-catastrophe impact shown separately for the three and nine months ended September 30, 2016 and 2015:

Table 8

Statutory Loss and LAE Ratios	(\$ millions)		%			Non-Cat Loss & ALAE Ratio	Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio		
Three months ended September 30							
<b>2016</b>							
<u>Specialty insurance segment:</u>							
E&S property	\$10.2	\$ —	\$2.6	\$2.6	—	25.2	25.2
E&S casualty	25.6	—	17.5	17.5	—	68.4	68.4
Programs	29.5	0.1	21.2	21.3	0.4	72.1	72.5
<i>Total specialty</i>	<b>65.3</b>	<b>0.1</b>	<b>41.3</b>	<b>41.4</b>	<b>0.2</b>	<b>63.2</b>	<b>63.4</b>
ULAE	—	—	—	2.5	—	—	3.9
<i>Total Loss and LAE</i>	<b>\$65.3</b>	<b>\$ 0.1</b>	<b>\$41.3</b>	<b>\$43.9</b>	<b>0.2</b>	<b>63.2</b>	<b>67.3</b>

2015

Specialty insurance segment:

E&S property	\$12.1	\$ —	\$2.5	\$2.5	0.3	19.9	20.2
E&S casualty	17.5	—	12.3	12.3	—	70.1	70.1
Programs	23.7	—	17.4	17.4	0.2	73.3	73.5
<i>Total specialty</i>	53.3	—	32.2	32.2	0.1	60.2	60.3
ULAE	—	—	—	1.8	—	—	3.4
<i>Total Loss and LAE</i>	\$53.3	\$ —	\$32.2	\$34.0	0.1	60.2	63.7

Table 9

Statutory Loss and LAE Ratios	(\$ millions)		%			Non-Cat Loss & ALAE Ratio	Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio		
Nine months ended September 30							
<b>2016</b>							
<u>Specialty insurance segment:</u>							
E&S property	\$29.9	\$ 0.4	\$9.4	\$9.8	1.2	31.6	32.8
E&S casualty	66.7	—	44.1	44.1	—	66.1	66.1
Programs	81.4	0.2	72.4	72.6	0.2	89.0	89.2
<i>Total specialty</i>	<b>178.0</b>	<b>0.6</b>	<b>125.9</b>	<b>126.5</b>	<b>0.3</b>	<b>70.7</b>	<b>71.0</b>
ULAE	—	—	—	8.3	—	—	4.7
<i>Total Loss and LAE</i>	<b>\$178.0</b>	<b>\$ 0.6</b>	<b>\$125.9</b>	<b>\$134.8</b>	<b>0.3</b>	<b>70.7</b>	<b>75.7</b>

2015

Specialty insurance segment:

E&S property	\$37.5	\$ 0.1	\$9.2	\$9.3	0.3	24.4	24.7
E&S casualty	43.5	—	28.4	28.4	—	65.2	65.2
Programs	64.8	0.1	45.7	45.8	0.2	70.5	70.7
<i>Total specialty</i>	145.8	0.2	83.3	83.5	0.1	57.2	57.3
ULAE	—	—	—	5.8	—	—	4.1
<i>Total Loss and LAE</i>	\$145.8	\$ 0.2	\$83.3	\$89.3	0.1	57.2	61.4

Net written premiums for the specialty insurance segment for the three and nine months ended September 30, 2016 increased 33.4% and 25.0%, respectively, compared to the same 2015 periods (Table 7). E&S casualty net written premiums increased 62.9% and 60.1%, respectively, for the three and nine months ended September 30, 2016, due to (i) continued organic growth

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within our general liability and umbrella lines and (ii) a change in the structure of the reinsurance treaty covering casualty risks within the specialty insurance segment (see "Reinsurance Arrangements" in this Item 2 for further information). Programs unit net written premiums increased 15.7% and 21.3%, respectively, for the three and nine months ended September 30, 2016 due to new programs added during the second half of 2015 and growth of existing programs. E&S property net written premiums for the nine months ended September 30, 2016 declined 13.2% compared to the same period in 2015 as continuing intense competition within the catastrophe-exposed property marketplace has contributed to less favorable pricing opportunities.

The specialty insurance segment's SAP non-catastrophe loss and ALAE ratio for the three and nine months ended September 30, 2016 were 63.2% and 70.7%, respectively, compared to 60.2% and 57.2%, respectively, for the same 2015 periods (Tables 8 - 9). The increase for the three months ended September 30, 2016 compared to the same 2015 period is primarily due to the shift in the mix of business attributable to net written premium and exposure growth within the E&S casualty unit. The mix of business shift also contributed to the non-catastrophe loss and ALAE ratio increase for the nine months ended September 30, 2016 compared to the same 2015 period, as did higher losses within the Programs unit. Elevated severity trends within programs with commercial auto exposures contributed to (i) higher 2016 accident year loss and ALAE ratios and (ii) adverse development of prior accident year losses.

During the quarter ended September 30, 2016, management completed an evaluation of business written within the Programs unit and determined this business was not core to our strategy. As a result, management decided to exit the programs business in order to further capitalize on our expertise within the E&S casualty and E&S property segments of the specialty marketplace. As a result of this decision, we will stop writing program business by the middle of 2017; however, exposure to the risks underlying this business will continue as the premiums are earned through mid-2018. Consistent with our past practices with respect to terminated programs, we will take the appropriate steps to implement more restrictive underwriting and referral guidelines in order to mitigate the potential for adverse selection and we will continue to conduct periodic underwriting audits of the program managers.

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*Losses and LAE Development*

Losses and loss expenses represent the combined estimated ultimate liability for claims occurring in a period, along with any change in the estimated ultimate liability for claims occurring in prior periods.

The following table sets forth a tabular presentation of the development of the prior accident years ultimate liability by line of business for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Three months ended September 30			Nine months ended September 30		
	2016	2015	\$ Change	2016	2015	\$ Change
	<i>Redundancy /(Deficiency)</i>			<i>Redundancy /(Deficiency)</i>		
Non-cat loss and ALAE:						
<u>Personal insurance segment:</u>						
Personal auto	<b>\$(0.6)</b>	\$(2.0)	\$ 1.4	<b>\$(8.5)</b>	\$(1.3)	\$(7.2)
Homeowners	<b>(0.2)</b>	0.3	(0.5)	<b>—</b>	1.8	(1.8)
Other personal	<b>—</b>	(0.1)	0.1	<b>0.1</b>	0.3	(0.2)
Personal segment	<b>(0.8)</b>	(1.8)	1.0	<b>(8.4)</b>	0.8	(9.2)
<u>Business insurance segment:</u>						
Commercial auto	<b>(0.3)</b>	(2.2)	1.9	<b>(4.8)</b>	(3.8)	(1.0)
Commercial multi-peril	<b>(1.1)</b>	0.6	(1.7)	<b>(2.4)</b>	0.7	(3.1)
Fire & allied lines	<b>(0.6)</b>	0.5	(1.1)	<b>(2.3)</b>	0.7	(3.0)
Other & product liability	<b>0.4</b>	3.3	(2.9)	<b>2.5</b>	6.5	(4.0)
Workers' compensation	<b>1.4</b>	1.1	0.3	<b>2.0</b>	3.5	(1.5)
Other commercial	<b>—</b>	0.1	(0.1)	<b>0.4</b>	0.7	(0.3)
Business segment	<b>(0.2)</b>	3.4	(3.6)	<b>(4.6)</b>	8.3	(12.9)
<u>Specialty insurance segment:</u>						
E&S property	<b>0.1</b>	1.2	(1.1)	<b>(1.1)</b>	1.7	(2.8)
E&S casualty	<b>(1.1)</b>	(1.8)	0.7	<b>(3.4)</b>	(0.2)	(3.2)
Programs	<b>(0.8)</b>	(1.9)	1.1	<b>(13.4)</b>	(4.5)	(8.9)
Specialty segment	<b>(1.8)</b>	(2.5)	0.7	<b>(17.9)</b>	(3.0)	(14.9)
Cat loss and ALAE	<b>0.3</b>	0.1	0.2	<b>1.3</b>	0.6	0.7
ULAE	<b>(0.7)</b>	1.8	(2.5)	<b>(3.8)</b>	5.5	(9.3)
<i>Total</i>	<b>\$(3.2)</b>	\$1.0	\$ (4.2)	<b>\$(33.4)</b>	\$12.2	\$(45.6)

For further information, see the "Personal Insurance Segment", "Business Insurance Segment" and "Specialty Insurance Segment" discussions included in this Item 2.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*Losses and loss expenses payable*

The following table sets forth losses and loss expenses payable by major line of business at September 30, 2016 and December 31, 2015:

<i>(\$ millions)</i>	<b>September</b>	December \$	
	<b>30, 2016</b>	31, 2015	Change
<u>Personal insurance segment:</u>			
Personal auto	<b>\$ 192.1</b>	\$ 182.1	\$ 10.0
Homeowners	<b>55.0</b>	37.2	17.8
Other personal	<b>8.6</b>	7.7	0.9
<i>Total personal</i>	<b>255.7</b>	227.0	28.7
<u>Business insurance segment:</u>			
Commercial auto	<b>104.7</b>	97.1	7.6
Commercial multi-peril	<b>119.1</b>	109.1	10.0
Fire & allied lines	<b>26.1</b>	17.4	8.7
Other & product liability	<b>169.9</b>	161.2	8.7
Workers' compensation	<b>181.8</b>	167.3	14.5
Other commercial	<b>2.3</b>	1.5	0.8
<i>Total business</i>	<b>603.9</b>	553.6	50.3
<u>Specialty insurance segment:</u>			
E&S property	<b>22.8</b>	21.4	1.4
E&S casualty	<b>125.9</b>	96.6	29.3
Programs	<b>153.2</b>	148.5	4.7
<i>Total specialty</i>	<b>301.9</b>	266.5	35.4
<i>Total losses and loss expenses payable, net of reinsurance recoverable on losses and loss expenses payable</i>	<b>\$ 1,161.5</b>	\$ 1,047.1	\$ 114.4

Losses and loss expenses payable increased \$114.4 million since December 31, 2015, primarily due to (i) exposure growth in workers' compensation and E&S casualty, (ii) increased bodily injury severity trends which resulted in increases in ultimate loss and ALAE estimates for current and prior accident years in personal auto, commercial auto and programs with auto exposures, and (iii) seasonality of weather-related catastrophe losses.

Losses and loss expenses payable for the nine months ended September 30, 2016 do not reflect the impact of Hurricane Matthew. We currently estimate the financial impact of Hurricane Matthew on fourth quarter results to be between \$8.0 million and \$10.0 million.

We conduct quarterly reviews of loss development reports and make judgments in determining the reserves for ultimate losses and loss expenses payable. Several factors are considered by us when estimating ultimate liabilities, including consistency in relative case reserve adequacy, consistency in claims settlement practices, recent legal developments, historical data, actuarial projections, accounting projections, exposure changes, anticipated inflation, current business conditions, catastrophe developments, late reported claims, and other reasonableness tests.

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



– Losses and Loss Expenses Payable” in Item 7 of the 2015 Form 10-K.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*Acquisition and Operating Expenses*

Our GAAP acquisition and operating expense ratios were 33.7% and 33.5%, respectively, for the three and nine months ended September 30, 2016 compared to 34.2% and 33.7%, respectively, for the same 2015 periods. The ratio decreased 0.5 points for the three months ended September 30, 2016, when compared to the same 2015 period, primarily due to decreases in personnel costs and incentive compensation.

**Investment Operations Segment**

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

We have investment policy guidelines with respect to purchasing fixed maturity investments for our insurance subsidiaries which preclude investments in bonds that are rated below investment grade by a recognized rating service at the time of purchase. Our fixed maturity portfolio is composed of high quality, investment grade issues, consisting primarily of debt issues rated AAA, AA or A. We obtain investment ratings from Moody's, Standard & Poor's and Fitch. If there is a split rating, we assign the lowest rating obtained. At September 30, 2016, there were two fixed maturity investments rated below investment grade in our available-for-sale investment portfolio.

For further discussion regarding the management of our investment portfolio, see "Management's Discussion and Analysis of Financial Condition and Results of Operations – Results of Operations – Investment Operations Segment" in Item 7 of the 2015 Form 10-K.

*Composition of Investment Portfolio*

The following table sets forth the composition of our investment portfolio at carrying value at September 30, 2016 and December 31, 2015:

<i>(\$ million)</i>	<b>September 30, 2016</b>	<b>% of Total</b>	December 31, 2015	<b>% of Total</b>
Cash and cash equivalents	<b>\$ 69.5</b>	<b>2.6</b>	\$ 58.1	2.3
Fixed maturities, at fair value:				
Fixed maturities	<b>1,996.7</b>	<b>74.7</b>	1,856.7	73.4
Treasury inflation-protected securities	<b>146.6</b>	<b>5.5</b>	144.0	5.7
<i>Total fixed maturities</i>	<b>2,143.3</b>	<b>80.2</b>	2,000.7	79.1
Notes receivable from affiliate	<b>70.0</b>	<b>2.6</b>	70.0	2.8

(a)

Equity  
securities,  
at  
fair  
value:

Large-cap securities <del>225.6</del>	<b>8.4</b>	241.0	9.5
Small-cap securities <del>71.9</del>	<b>2.7</b>	69.6	2.8
<i>Total equity securities</i> <del>297.5</del>	<b>11.1</b>	310.6	12.3
Other invested assets, at fair value:			
International funds <del>80.7</del>	<b>3.0</b>	77.0	3.0
Other invested assets <del>9.0</del>	<b>0.3</b>	8.1	0.3
<i>Total other invested assets</i> <del>89.7</del>	<b>3.3</b>	85.1	3.3
Other invested assets, at cost <del>5.4</del>	<b>0.2</b>	5.3	0.2
<i>Total portfolio</i> <del>\$ 2,675.4</del>	<b>100.0</b>	\$ 2,529.8	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 semi-annually at a fixed annual interest rate of 7.00%. Principal is payable May 2019.

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at September 30, 2016:

(\$ millions)	Amortized Fair	
	cost	value
Due in 1 year or less	<b>\$ 67.1</b>	<b>\$68.1</b>
Due after 1 year through 5 years	<b>564.0</b>	<b>579.4</b>
Due after 5 years through 10 years	<b>275.3</b>	<b>286.1</b>
Due after 10 years	<b>584.9</b>	<b>618.8</b>
U.S. government agencies mortgage-backed securities	<b>569.7</b>	<b>590.9</b>
<i>Total</i>	<b>\$ 2,061.0</b>	<b>\$2,143.3</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 4.52 and 4.85 as of September 30, 2016 and December 31, 2015, respectively.

*Investment Operations Revenue*

The following table sets forth the components of net investment income for the three and nine months ended September 30, 2016 and 2015:

(\$ millions)	Three months ended		Nine months ended		
	September 30		September 30		
	<b>2016</b>	2015	<b>2016</b>	2015	
Gross investment income:					
Fixed maturities	<b>\$15.4</b>	\$16.1	<b>\$47.0</b>	\$46.4	
Equity securities	<b>1.3</b>	1.4	<b>4.3</b>	4.7	
Other	<b>1.4</b>	1.6	<b>4.1</b>	4.3	
<i>Total gross investment income</i>	<b>18.1</b>	19.1	<b>55.4</b>	55.4	
Less: Investment expenses	<b>0.5</b>	0.4	<b>1.3</b>	1.5	
<i>Net investment income</i>	<b>\$17.6</b>	\$18.7	<b>\$54.1</b>	\$53.9	
Average invested assets (at cost)	<b>\$2,427.3</b>	\$2,311.5	<b>\$2,405.7</b>	\$2,268.7	
Annualized investment yield	<b>2.9</b>	% 3.2	<b>% 3.0</b>	% 3.2	%
Annualized investment yield, after tax	<b>2.2</b>	% 2.5	<b>% 2.3</b>	% 2.4	%
Net investment income, after tax	<b>\$13.1</b>	\$14.3	<b>\$40.7</b>	\$41.6	
Effective tax rate	<b>25.5</b>	% 23.7	<b>% 24.8</b>	% 22.8	%

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth realized gains and the proceeds received from the sale of our investment portfolio for the three and nine months ended September 30, 2016 and 2015:

(\$ in millions)	Three months ended				Nine months ended September			
	September 30		2015		2016		2015	
	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale
Realized gains:								
Fixed maturities	\$—	\$11.6	\$2.9	\$73.8	\$2.1	\$138.0	\$4.4	\$142.7
Equity securities	9.9	49.0	11.8	76.2	20.6	109.5	21.8	111.3
Other invested assets	—	0.3	—	0.2	0.1	0.7	0.1	0.5
<i>Total realized gains</i>	<b>9.9</b>	<b>60.9</b>	14.7	150.2	<b>22.8</b>	<b>248.2</b>	26.3	254.5
Realized losses:								
Equity securities:								
Sales	—	(0.1)	(0.4)	1.4	(0.8)	4.4	(1.1)	6.1
OTTI	(1.1)	—	(3.5)	—	(3.1)	—	(4.8)	—
Fixed maturities								
OTTI	—	—	—	—	(2.3)	—	—	—
Total realized losses	(1.1)	(0.1)	(3.9)	1.4	(6.2)	4.4	(5.9)	6.1
<i>Net realized gains on investments</i>	<b>\$8.8</b>	<b>\$60.8</b>	\$10.8	\$151.6	<b>\$16.6</b>	<b>\$252.6</b>	\$20.4	\$260.6

Net realized gains decreased \$2.0 million and \$3.8 million, respectively, for the three and nine months ended September 30, 2016 when compared to the same 2015 period, partially driven by an increase in realized gains in the fixed income portfolio in the third quarter of 2015 as a result of reducing our TIPS position due to our inflation outlook. Year to date net realized gains were also impacted by OTTI recognized on our fixed maturity portfolio (discussed below).

When a fixed maturity security has been determined to have an other-than-temporary decline in fair value, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies – Investments” included in Item 7 of the 2015 Form 10-K for other-than-temporary impairment (“OTTI”) indicators. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income. We did not recognize any OTTI on our fixed maturity portfolio for the three months ended September 30, 2016 and we recognized \$2.3 million of OTTI on our fixed maturity portfolio for the nine months ended September 30, 2016. We did not recognize any OTTI on our fixed maturity portfolio for the three and nine months ended September 30, 2015.

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 2015 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.



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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth the realized losses related to OTTI on our investment portfolio recognized for the three and nine months ended September 30, 2016 and 2015:

	Three months ended		Nine months ended	
	September 30		September 30	
	2016	2015	2016	2015
	Number of positions with impairment	Number of positions with impairment	Number of positions with impairment	Number of positions with impairment
Equity securities:				
Large-cap securities	—	—	1	—
Small-cap securities	8 (1.1 )	22 (3.5 )	22 (2.9 )	36 (4.8 )
Fixed maturities	—	—	1 (2.3 )	—
<i>Total other-than-temporary impairments</i>	<b>8 \$ (1.1 )</b>	<b>22 \$ (3.5 )</b>	<b>24 \$ (5.4 )</b>	<b>36 \$ (4.8 )</b>

*Gross Unrealized Investment Gains and Losses*

Based upon our review of our investment portfolio at September 30, 2016, we determined that there were no individual investments with an unrealized holding loss that had a fair value significantly below cost continually for more than one year. The following table sets forth detailed information on our available-for-sale investment portfolio by lot at fair value for our gross unrealized holding gains (losses) at September 30, 2016:

	Cost or amortized cost	Gross unrealized holding gains	Number of gross unrealized gain positions	Number of gross unrealized holding losses	Number of loss positions	Fair value
Fixed maturities:						
U.S. treasury securities and obligations of U.S. government agencies	\$316.8	\$14.3	35	8	8	\$330.9
Obligations of states and political subdivisions	664.1	34.5	188	—	—	698.6
Corporate securities	510.4	13.1	81	10	10	522.9
U.S. government agencies mortgage-backed securities	569.7	22.4	75	20	20	590.9
<i>Total fixed maturities</i>	<b>2,061.0</b>	<b>84.3</b>	<b>379</b>	<b>(2.0 )</b>	<b>38</b>	<b>2,143.3</b>
Equity securities:						
Large-cap securities	193.1	37.1	37	16	16	225.6
Small-cap securities	53.0	18.9	67	—	—	71.9
<i>Total equity securities</i>	<b>246.1</b>	<b>56.0</b>	<b>104</b>	<b>(4.6 )</b>	<b>16</b>	<b>297.5</b>
Other invested assets	57.1	32.6	2	—	—	89.7
<i>Total available-for-sale investments</i>	<b>\$2,364.2</b>	<b>\$172.9</b>	<b>485</b>	<b>\$ (6.6 )</b>	<b>54</b>	<b>\$2,530.5</b>

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following table sets forth our unrealized holding gains by investment type, net of deferred tax that was included as a component of accumulated other comprehensive income at September 30, 2016 and December 31, 2015, and the change in unrealized holding gains, net of deferred tax, for the nine months ended September 30, 2016:

<i>(\$ millions)</i>	<b>September 30, 2016</b>	December 31, 2015	\$ Change
Available-for-sale investments:			
Unrealized holding gains:			
Fixed maturities	<b>\$ 82.3</b>	\$ 27.8	\$ 54.5
Equity securities	<b>51.4</b>	45.4	6.0
Other invested assets	<b>32.6</b>	28.2	4.4
<i>Unrealized gains</i>	<b>166.3</b>	101.4	64.9
Net deferred federal income tax liability	<b>(55.7 )</b>	(32.9 )	(22.8 )
<i>Unrealized gains, net of tax</i>	<b>\$ 110.6</b>	\$ 68.5	\$ 42.1

**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 September 30, 2016 and December 31, 2015.

As of September 30, 2016, Level 3 assets as a percentage of total assets were 0.1% which we have determined to be insignificant.

**Other Items***Income Taxes*

The following table sets forth the components of our federal income tax expense for the three and nine months ended September 30, 2016 and 2015, respectively.

<i>(\$ millions)</i>	Three months ended September 30 <b>2016</b>	Nine months ended September 30 <b>2016</b>	Three months ended September 30 2015	Nine months ended September 30 2015
Income (loss) before federal income taxes	<b>\$7.4</b>	\$29.9	<b>\$(13.9)</b>	\$66.5
Current tax (benefit) expense	<b>(1.5 )</b>	2.7	<b>(1.5 )</b>	3.3
Deferred tax (benefit) expense	<b>(1.2 )</b>	6.5	<b>(0.9 )</b>	15.1
Total federal income tax (benefit) expense	<b>(2.7 )</b>	9.2	<b>(2.4 )</b>	18.4
<i>Net income (loss)</i>	<b>\$10.1</b>	\$20.7	<b>\$(11.5)</b>	\$48.1

Income taxes for the nine months ended September 30, 2016 reflect the impact of a correction of prior period deferred tax expense related to expired stock options. As a result of the correction, deferred federal income tax expense and additional paid-in-capital were reduced by \$1.6 million, respectively.



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Effective tax rates were (36.2)% and 17.0%, respectively, for the three and nine months ended September 30, 2016 and 30.8% and 27.7%, respectively, for the same 2015 periods. For additional information, see Note 6 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

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

**Liquidity**

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

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

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

We generally manage our cash flows through current operational activity and maturing investments, without a need to liquidate any of our other investments; however, should our written premiums decline or paid losses increase significantly, or a combination thereof, we may need to liquidate investments at losses in order to meet our cash obligations. This action was not necessary for the three and nine months ended September 30, 2016.

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 September 30, 2016 and December 31, 2015, we had \$69.5 million and \$58.1 million, respectively, in cash and cash equivalents, and \$2,530.5 million and \$2,396.4 million, respectively, of total available-for-sale investments. Our fixed maturities available-for-sale included \$9.2 million and \$8.8 million of securities on deposit with insurance regulators as required by law at September 30, 2016 and December 31, 2015; in addition, substantially all of our fixed maturity and equity securities are traded on public markets. For a further discussion regarding investments, see "Investments Operations Segment" included in this Item 2.

Cash provided by operating activities was \$62.0 million and \$108.5 million for the nine months ended September 30, 2016 and 2015, respectively. Net cash provided by operating activities for the nine months ended September 30, 2016 included contributions to the Company's pension plan of \$34.5 million, which includes use of the proceeds from the 2016 FHLB Loan (as defined in the "Borrowing Arrangements" discussion included in this Item 2). Net cash provided by operating activities for the nine months ended September 30, 2015 included a return of \$63.5 million of premiums due to the expiration of the homeowners quota share reinsurance arrangement ("HO QS Arrangement") at December 31, 2014. Net cash from operations will vary from

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period to period if there are significant changes in underwriting results, primarily a combination of the level of premiums written and loss and loss expenses paid, changes in cash flows from investment income or federal income tax activity.

Cash used in investing activities was \$63.8 million and \$134.2 million for the nine months ended September 30, 2016 and 2015, respectively. The change was primarily driven by (i) a decrease in fixed maturity, equity, and other invested asset purchases in 2016 compared to the same 2015 period, and (ii) the reinvestment of proceeds received from the expiration of the HO QS Arrangement in the first half of 2015.

Cash provided by financing activities was \$13.2 million for the nine months ended September 30, 2016 compared to cash used in of \$9.7 million for the same 2015 period. The increase year over year was primarily driven by proceeds from the new term loan with the Federal Home Loan Bank of Cincinnati ("the "FHLB") in the principal amount of \$21.5 million.

**Borrowing Arrangements**

*Credit Facility*

State Auto P&C has a \$100.0 million five-year revolving credit facility (the "Credit Facility") maturing in July 2018 with a syndicate of lenders. During the term of the Credit Facility, State Auto P&C has the right to increase the total facility to a maximum amount of \$150.0 million, provided that no event of default has occurred and is continuing. The Credit Facility is available for general corporate purposes and provides for interest-only payments during its term, with principal and interest due in full at maturity. Interest is based on LIBOR or a base rate plus a calculated margin amount. All advances under the Credit Facility are to be fully secured by a pledge of specific investment securities of State Auto P&C. The Credit Facility includes certain covenants and requirements, including financial requirements that State Auto Financial maintain a minimum net worth and a certain debt to capitalization ratio. As of September 30, 2016, State Auto P&C had not made any borrowings under the Credit Facility and State Auto P&C and State Auto Financial were in compliance with all covenants and requirements of the Credit Facility.

*FHLB Loans*

In September 2016, State Auto P&C entered into a new term loan with the FHLB in the principal amount of \$21.5 million (the "2016 FHLB Loan"). The 2016 FHLB Loan is a five-year term loan and may be called (prepaid) after three years with no prepayment penalty. The 2016 FHLB Loan provides for interest-only payments during its term, with principal due in full at maturity. The interest rate is fixed over the term of the loan at 1.73%. Proceeds from the loan were contributed to the pension plan to reduce the Company's future pension costs. For the nine months ended September 30, 2016, the Company contributed \$34.5 million to its pension plan.

In addition, State Auto P&C has outstanding an \$85.0 million loan ("2013 FHLB Loan") from the FHLB. The 2013 FHLB Loan is a 20-year term loan that may be currently called (prepaid) at any time with no prepayment penalty. The interest rate is fixed over the term of the loan at 5.03%.

The 2013 and 2016 FHLB Loans are fully secured by a pledge of specific investment securities of State Auto P&C.

*Subordinated Debentures*

State Auto Financial's Delaware business trust subsidiary (the "Capital Trust") has outstanding \$15.0 million liquidation amount of capital securities, due 2033. In connection with the Capital Trust's issuance of the capital securities and the related purchase by State Auto Financial of all of the Capital Trust's common securities (liquidation amount of \$0.5 million), State Auto Financial has issued to the Capital Trust \$15.5 million aggregate principal amount of unsecured Floating Rate Junior Subordinated Debt Securities due 2033 (the "Subordinated Debentures"). The sole assets of the Capital Trust are the Subordinated Debentures and any interest accrued thereon. Interest on the Capital Trust's capital and common securities is payable quarterly at a rate equal to the three-month LIBOR rate plus 4.20%, adjusted quarterly. The applicable interest rates for September 30, 2016 and 2015 were 5.04% and 4.53%, respectively.

**Reinsurance Arrangements**

Members of the State Auto Group follow the customary industry practice of reinsuring a portion of their exposures and paying to the reinsurers a portion of the premiums received. Insurance is ceded principally to reduce net liability

on individual risks or for individual loss occurrences, including catastrophic losses. Although reinsurance does not legally discharge the individual members of the State Auto Group from primary liability for the full amount of limits applicable under their policies, it does make the assuming reinsurer liable to the extent of the reinsurance ceded.

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To minimize the risk of reinsurer default, the State Auto Group cedes only to third-party reinsurers who are rated A- or better by A.M. Best or Standard & Poor's and also utilizes both domestic and international markets to diversify its credit risk. We utilize reinsurance to limit our loss exposure and contribute to our liquidity and capital resources. Each member of the State Auto Group is party to working reinsurance treaties for casualty, workers' compensation and property lines with several reinsurers arranged through reinsurance intermediaries. We have also secured other reinsurance to limit the net cost of large loss events for certain types of coverage. The State Auto Group also makes use of facultative reinsurance for unique risk situations. The State Auto Group also participates in state insurance pools and associations. In general, these pools and associations are state sponsored and/or operated, impose mandatory participation by insurers doing business in that state, and offer coverage for hard-to-place risks at premium rates established by the state sponsor or operator, thereby transferring risk of loss to the participating insurers in exchange for premiums which may not be commensurate with the risk assumed.

Certain of our reinsurance agreements are described below. The rates for these reinsurance agreements are negotiated annually. For a discussion of our other reinsurance arrangements see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Reinsurance Arrangements" in Item 7 of the 2015 Form 10-K.

*Property Catastrophe*

Members of the State Auto Group maintain a property catastrophe excess of loss reinsurance agreement, covering property catastrophe related events affecting at least two risks. As of June 1, 2016, this property catastrophe reinsurance agreement renewed. Under this reinsurance agreement, we retain the first \$55.0 million of catastrophe loss, each occurrence, with a 5.0% co-participation on the next \$285.0 million of covered loss, each occurrence. The reinsurers are responsible for 95.0% of the excess over \$55.0 million up to \$340.0 million of covered losses, each occurrence. Under this reinsurance agreement, the State Auto Group is responsible for losses above \$340.0 million. The State Auto Group also maintains a separate property catastrophe excess of loss reinsurance agreement covering the specialty insurance segment's E&S property and programs units catastrophe related events affecting at least two risks. Under this reinsurance agreement, the State Auto Group retains the \$30.0 million of catastrophe loss, each occurrence, with no co-participation on the next \$25.0 million of covered loss, each occurrence.

*Property Per Risk*

As of June 1, 2016, the State Auto Group renewed the property per risk excess of loss reinsurance agreement. This reinsurance agreement provides that the State Auto Group is responsible for the first \$3.0 million of losses, subject to an additional \$2.0 million annual aggregate deductible ("AAD"). The reinsurers are responsible for 100.0% of the loss excess of the \$3.0 million retention and \$2.0 million AAD for property business up to \$20.0 million of covered loss.

*Casualty and Workers' Compensation*

As of July 1, 2016, the State Auto Group renewed our casualty excess of loss reinsurance agreement. Under this reinsurance agreement, the State Auto Group is responsible for the first \$2.0 million of losses that involve workers' compensation, auto liability, other liability and umbrella liability policies, subject to an additional \$2.0 million AAD. This reinsurance agreement provides coverage up to \$10.0 million, except for umbrella policies which are covered for limits up to \$15.0 million. E&S casualty and programs units risks are not subject to this casualty excess of loss reinsurance agreement.

Also, certain unusual claim situations involving extra contractual obligations, excess of policy limits, LAE coverage and multiple policy or coverage loss occurrences arising from bodily injury liability, property damage, uninsured motorist and personal injury protection are covered by a Clash reinsurance agreement that provides for \$30.0 million of coverage in excess of \$10.0 million retention for each loss occurrence. This reinsurance coverage sits above the \$8.0 million excess of \$2.0 million arrangement. Policies underwritten by the E&S casualty and programs units are not subject to this casualty excess of loss reinsurance agreement.

In addition, each company in the State Auto Group is party to a workers' compensation catastrophe reinsurance agreement that provides additional reinsurance coverage for workers' compensation losses involving multiple workers.

Subject to \$10.0 million of retention, reinsurers are responsible for 100.0% of the excess over \$10.0 million up to \$30.0 million of covered loss. For loss amounts over \$30.0 million, the casualty excess of loss reinsurance agreement provides \$20.0 million coverage in excess of \$30.0 million. Workers' compensation catastrophe coverage is subject to a "Maximum Any One Life" limitation of \$10.0 million. This limitation means that losses associated with each worker may contribute no more than \$10.0 million to covered loss under these agreements.

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As of July 1, 2016, the State Auto Group restructured its reinsurance coverage for E&S casualty and programs units casualty risks. Under this reinsurance agreement, the State Auto Group is responsible for the first \$2.0 million of losses. This reinsurance agreement provides 100.0% coverage up to \$9.0 million excess of \$2.0 million for any one insured, all policies, and \$14.0 million excess of \$11.0 million for Clash only coverage. This reinsurance arrangement is placed on a loss occurrence basis, while the expired treaty was placed on a risk-attaching basis. As a result of this change, the 2015 reinsurance treaty was terminated on a cut-off basis, resulting in the return of \$5.1 million of ceded unearned premium from the reinsurers to the Company.

**Regulatory Considerations**

At September 30, 2016, all of our insurance subsidiaries were in compliance with statutory requirements relating to capital adequacy.

**ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS**

*Simplifying the Presentation of Debt Issuance Costs*

The amendments in this guidance simplify the presentation of debt issuance costs by requiring them to be presented in the balance sheet as a direct deduction from the carrying amount of the related recognized debt liability, consistent with debt discounts. We adopted this guidance at January 1, 2016 on a retrospective basis and it resulted in a \$0.3 million decrease to notes payable and accrued investment income and other assets at December 31, 2015.

*Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*

The amendments in this guidance remove the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years and should be applied retrospectively to all periods presented. We adopted this guidance at January 1, 2016 and it did not have a material impact on the condensed consolidated financial statements.

**CREDIT AND FINANCIAL STRENGTH RATINGS**

There were no changes to our credit or financial strength ratings during the third quarter of 2016.

**MARKET RISK**

With respect to Market Risk, see the discussion regarding this subject at “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Investment Operations Segment – Market Risk” in Item 7 of the 2015 Form 10-K. There have been no material changes from the information reported regarding Market Risk in the 2015 Form 10-K.

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

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



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**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: