

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

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
<b>September 30, 2016</b>				
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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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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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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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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*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>	<i>2,000.7</i>	<i>—</i>	<i>1,997.4</i>	<i>3.3</i>
Equity securities:				
Large-cap securities	241.0	241.0	—	—
Small-cap securities	69.6	69.6	—	—
<i>Total equity securities</i>	<i>310.6</i>	<i>310.6</i>	<i>—</i>	<i>—</i>
Other invested assets	8.1	8.1	—	—
<i>Total available-for-sale investments</i>	<i>\$2,319.4</i>	<i>\$318.7</i>	<i>\$1,997.4</i>	<i>\$3.3</i>

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## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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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 to Condensed Consolidated Financial Statements, Continued (Unaudited)

*Notes Receivable from Affiliate*

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

(\$ millions, except interest rates)

	September 30, 2016			December 31, 2015		
	Carrying value	Fair value	Interest rate	Carrying value	Fair value	Interest 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 value	Fair Value	Interest rate	Carrying value	Fair value	Interest 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:

<i>(\$ millions)</i>	Three months ended September 30 <b>2016</b>	2015	Nine months ended September 30 <b>2016</b>	2015
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Premiums earned: