State Auto Financial CORP
Form 10-Q
November 05, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2008

or

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

Commission File Number 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

Ohio	**31-1324304**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
518 East Broad Street, Columbus, Ohio	**43215-3976**
(Address of principal executive offices)	**(Zip Code)**

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

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

Yes x No ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Yes ¨ No x

On October 31, 2008, the Registrant had 39,556,849 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

($ millions, except per share amount)	**September 30 2008** (unaudited)	December 31 2007 (see note 1)
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost $1,812.1 and $1,722.9, respectively)	**$ 1,756.0**	1,745.4
Equity securities, available-for-sale, at fair value (cost $179.1 and $210.2, respectively)	**191.7**	254.2
Other invested assets, available-for-sale, at fair value (cost $44.0 and $20.1, respectively)	**36.2**	20.3
Other invested assets	**1.1**	1.3
Total investments	**1,985.0**	2,021.2
Cash and cash equivalents	**89.1**	70.9
Accrued investment income and other assets	**43.5**	42.1
Deferred policy acquisition costs	**125.8**	105.8
Pension asset	**7.8**	2.7
Reinsurance recoverable on losses and loss expenses payable (affiliates $0.8 and $1.2, respectively)	**29.2**	11.2
Prepaid reinsurance premiums	**7.0**	6.0
Due from affiliate	**6.7**	19.4
Current federal income taxes	**41.4**	
Deferred federal income taxes	**94.2**	46.1
Property and equipment, at cost (net of accumulated depreciation of $6.1 and $5.6, respectively)	**12.5**	12.5
Total assets	**$ 2,442.2**	2,337.9
Liabilities and Stockholders Equity		
Losses and loss expenses payable (affiliates $367.1 and $257.2, respectively)	**$ 845.8**	658.3
Unearned premiums (affiliates $174.7 and $119.5, respectively)	**520.1**	436.0
Notes payable (affiliates $15.5 and $15.5, respectively)	**117.7**	118.0
Postretirement benefits	**128.8**	125.2
Current federal income taxes		7.8
Other liabilities	**42.0**	57.1
Total liabilities	**1,654.4**	1,402.4
Stockholders equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		

Class B Preferred stock, without par value. Authorized 2.5 shares; none issued			
Common stock, without par value. Authorized 100.0 shares; 46.3 and 46.0 shares issued, respectively, at stated value of $2.50 per share		**115.7**	115.0
Treasury stock, 6.8 and 5.5 shares, respectively, at cost		**(115.5)**	(81.0)
Additional paid-in capital		**107.1**	98.2
Accumulated other comprehensive loss		**(75.3)**	(3.3)
Retained earnings		**755.8**	806.6
Total stockholders equity		**787.8**	935.5
Total liabilities and stockholders equity	**$**	**2,442.2**	2,337.9

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

($ millions, except per share amounts)	Three months ended September 30	
(unaudited)	**2008**	2007
Earned premiums (ceded to affiliates $175.4 and $174.1, respectively)	**$ 280.7**	252.1
Net investment income	**23.0**	21.1
Net realized (losses) gains on investments	**(4.3)**	6.4
Other income (affiliates $0.8 and $0.8, respectively)	**1.2**	1.3
Total revenues	**300.6**	280.9
Losses and loss expenses (ceded to affiliates $126.7 and $115.4, respectively)	**231.2**	164.6
Acquisition and operating expenses	**94.9**	82.6
Interest expense (affiliates $0.3 and $0.4, respectively)	**1.8**	1.9
Other expenses, net	**2.9**	3.2
Total expenses	**330.8**	252.3
(Loss) income before federal income taxes	**(30.2)**	28.6
Federal income tax (benefit) expense	**(15.5)**	5.4
Net (loss) income	**(14.7)**	23.2
(Loss) earnings per common share:		
Basic	**$ (0.37)**	0.56
Diluted	**$ (0.37)**	0.55
Dividends paid per common share	**$ 0.15**	0.15

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

($ millions, except per share amounts)	Nine months ended September 30	
(unaudited)	**2008**	2007
Earned premiums (ceded to affiliates $522.2 and $520.6, respectively)	**$ 841.0**	757.3
Net investment income	**67.7**	63.0
Net realized (losses) gains on investments	**(3.7)**	11.1
Other income (affiliates $2.4 and $2.4, respectively)	**3.6**	3.7
Total revenues	**908.6**	835.1
Losses and loss expenses (ceded to affiliates $421.4 and $315.9, respectively)	**681.9**	468.0
Acquisition and operating expenses	**280.9**	254.0
Interest expense (affiliates $0.9 and $1.1, respectively)	**5.5**	5.6
Other expenses, net	**9.7**	9.2
Total expenses	**978.0**	736.8
(Loss) income before federal income taxes	**(69.4)**	98.3
Federal income tax (benefit) expense	**(38.9)**	20.9
Net (loss) income	**$ (30.5)**	77.4
(Loss) earnings per common share:		
Basic	**$ (0.77)**	1.88
Diluted	**$ (0.77)**	1.86
Dividends paid per common share	**$ 0.45**	0.35

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

($ millions)	Nine months ended September 30	
(unaudited)	**2008**	2007
Cash flows from operating activities:		
Net (loss) income	**$ (30.5)**	77.4
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization, net	**6.4**	8.3
Share-based compensation	**4.8**	4.9
Net realized losses (gains) on investments	**3.7**	(11.1)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	**(7.2)**	(3.9)
Accrued investment income and other assets	**(2.0)**	(1.1)
Postretirement and pension benefit assets	**4.0**	2.4
Other liabilities and due to/from affiliates, net	**(2.8)**	(18.5)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	**(19.0)**	1.5
Losses and loss expenses payable	**136.2**	16.0
Unearned premiums	**30.5**	19.8
Excess tax benefits on share based awards	**0.4**	0.2
Federal income taxes	**(59.0)**	(18.8)
Cash provided from Pooling Arrangement Amendment effective January 1, 2008	**92.0**	
Net cash provided by operating activities	**157.5**	77.1
Cash flows from investing activities:		
Purchases of fixed maturities available-for-sale	**(253.9)**	(280.6)
Purchases of equity securities available-for-sale	**(27.2)**	(34.9)
Purchases of other invested assets	**(24.7)**	(0.7)
Maturities, calls and pay downs of fixed maturities available-for-sale	**41.3**	68.6
Sales of fixed maturities available-for-sale	**119.3**	148.0
Sales of equity securities available-for-sale	**53.0**	77.5
Sales of other invested assets	**0.9**	1.7
Net additions of property and equipment	**(0.4)**	(0.4)
Net cash used in investing activities	**(91.7)**	(20.8)
Cash flows from financing activities:		
Proceeds from issuance of common stock	**3.1**	2.5
Payments to acquire treasury shares	**(33.2)**	(2.7)
Excess tax benefits on share based awards	**0.4**	0.2
Payment of dividends	**(17.9)**	(14.5)

Net cash used in financing activities	**(47.6)**	(14.5)
Net increase in cash and cash equivalents	**18.2**	41.8
Cash and cash equivalents at beginning of period	**70.9**	73.4
Cash and cash equivalents at end of period	**$ 89.1**	115.2
Supplemental disclosures:		
Federal income taxes paid	**$ 18.0**	39.3
Interest paid (to affiliates $0.9 and $1.1, respectively)	**$ 4.1**	4.2

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)

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation (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 for complete financial statements. In the opinion of the Company s management, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine month period ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ended December 31, 2008. The balance sheet at December 31, 2007 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required 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, 2007 (the 2007 Form 10-K). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2007 Form 10-K.

Adoption of Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158) that requires employers of defined benefit pension and postretirement benefit plans other than pensions (collectively benefit plans) to recognize the funded status of their benefit plans in their balance sheet, measure the fair value of plan assets and benefit obligations as of the date of the year-end balance sheet date thereby eliminating the use of an earlier measurement date and provide additional disclosures. The new measurement date requirement was not effective until fiscal years ending after December 15, 2008. The Company adopted the recognition and disclosures provision on December 31, 2006. Effective January 1, 2008, the Company adopted the measurement date requirement under transition alternative method one, as defined in SFAS 158. This transition method resulted in a one-time adjustment that decreased beginning retained earnings by $2.4 million, net of tax. The combined impact of the measurement date transition and re-measurement of plan assets and obligations on January 1, 2008, increased beginning accumulated comprehensive income by $3.5 million, net of tax.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. The Statement imposes no new requirements for additional fair-value measures in financial statements. The Company adopted the provisions of SFAS 157 on January 1, 2008. The adoption of SFAS 157 did not require any adjustments to the Company s previously reported financial statements. See Note 2 for interim period required disclosures.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 expands the standards under SFAS 157 to provide entities a one-time election to measure financial instruments and certain other items at fair value. SFAS 159 also amends SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities to require a specific presentation of investments categorized as available-for-sale. This Statement is effective for the first year that begins after November 15, 2007. The Company adopted this guidance effective January 1, 2008 and did not elect the fair value option for any of its eligible assets or liabilities as of this date.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Pending Adoption of Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141(R)). This Statement replaces SFAS No. 141, Business Combinations (SFAS 141) and establishes the principles and requirements for how the acquirer in a business combination: (a) measures and recognizes the identifiable assets acquired, liabilities assumed, and any noncontrolling interests in the acquired entity, (b) measures and recognizes positive goodwill acquired or a gain from bargain purchase (negative goodwill), and (c) determines the disclosure information that is decision-useful to users of financial statements in evaluating the nature and financial effects of the business combination. SFAS 141(R) is effective for and shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period after December 15, 2008, with earlier adoption prohibited. Assets and liabilities that arose from business combinations with acquisition dates prior to the SFAS 141(R) effective date shall not be adjusted upon adoption of SFAS 141(R) with certain exceptions for acquired deferred tax assets and acquired income tax positions. The Company plans to adopt this guidance effective January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS 160). This Statement amends Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51). Noncontrolling interest refers to the minority interest portion of the equity of a subsidiary that is not attributable directly or indirectly to a parent. SFAS 160 establishes accounting and reporting standards that require for-profit entities that prepare consolidated financial statements to: (a) present noncontrolling interests as a component of equity, separate from the parent s equity, (b) separately present the amount of consolidated net income attributable to noncontrolling interests in the income statement, (c) consistently account for changes in a parent s ownership interests in a subsidiary in which the parent entity has a controlling financial interest as equity transactions, (d) require an entity to measure at fair value its remaining interest in a subsidiary that is deconsolidated, (e) require an entity to provide sufficient disclosures that identify and clearly distinguish between interests of the parent and interests of noncontrolling owners. SFAS 160 applies to all for-profit entities that prepare consolidated financial statements, and affects those for-profit entities that have outstanding noncontrolling interests in one or more subsidiaries or that deconsolidate a subsidiary. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 with earlier adoption prohibited. The Company does not expect the adoption of this Statement to have a material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161 Disclosures about Derivative Instruments and Hedging Activities (SFAS 161). This Statement amends FASB Statement No. 133 Accounting for Derivative Instruments and Hedging Activities (SFAS 133). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. SFAS 161 applies to all entities that have derivatives within the scope of SFAS 133. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. SFAS 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company plans to adopt this guidance effective January 1, 2009.

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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. Fair Value Measurements

On January 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 s definition of fair value focuses on the price that would be received to sell an asset or paid to transfer a liability (exit price) regardless of whether an observable liquid market price exists. An exit price valuation is to include margins for credit risk and liquidity even if they are not observable.

SFAS 157 established a fair value hierarchy that categorizes the inputs to valuation techniques that are used to measure fair value into three levels:

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 current market participants would use in pricing the asset or liability (including assumptions about risk).

Fixed Maturities

The Company uses inputs that include published exchange prices for identical or similar assets and other procedures to estimate fair value measurements for approximately 99% of its fixed maturities. When quoted prices in active markets are not available fair values are derived through matrix pricing, which is a mathematical technique used principally to value debt securities by relying on the securities relationship to other benchmark quoted securities and not by relying exclusively on quoted prices for specific securities. Inputs to the applications 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 Company includes these prices in the amounts disclosed in Level 2 of the hierarchy.

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

Equities

The fair values of our equity securities are based on observable market quotations for identical assets and have been disclosed in Level 1.

Other invested assets

Other invested assets managed by third party investment managers are based on values provided to the Company by such managers based on operating results, balance sheet stability, growth and other business and market sector fundamentals. Due to the significant unobservable inputs in these valuations, the Company includes the estimate on the amount disclosed in Level 3. The remainder of the Company s other invested assets consist primarily of holdings in publicly-traded mutual funds. The Company believes that its estimates for these publicly-traded mutual funds reasonably reflect their fair values and consequently these securities have been disclosed in Level 1.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The table below summarizes the Company s available-for-sale investments within the fair value hierarchy at September 30, 2008:

$ millions		Fair Value Measurements Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale investments:				
Fixed maturities	$ 1,756.0		1,753.8	2.2
Equity securities	191.7	191.7		
Other invested assets	36.2	3.4		32.8
Total	$ 1,983.9	195.1	1,753.8	35.0

For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the quarter, a reconciliation of the beginning and ending balances, separately for each major category of assets is as follows:

Fair Value Measurements Using Significant Unobservable Inputs (Level 3) for the three months ended

September 30, 2008

$ millions	Fixed Maturities	Other Invested Assets
Beginning balance at July 1, 2008	$ 2.1	29.7
Total gains or losses (realized)		
included in other comprehensive income - total gains or (losses) unrealized	0.1	(4.9)
Purchases, issuances, and settlements		8.0
Transfers in and/or out of Level 3		
Ending balance at September 30, 2008	$ 2.2	32.8

Fair Value Measurements Using Significant Unobservable Inputs (Level 3) for the nine months ended

September 30, 2008

$ millions

	Fixed Maturities	Other Invested Assets
Beginning balance at January 1, 2008	$ 2.1	16.3
Total gains or losses (realized)		
included in other comprehensive income - total gains or (losses) unrealized	0.1	(7.5)
Purchases, issuances, and settlements		24.0
Transfers in and/or out of Level 3		
Ending balance at September 30, 2008	$ 2.2	32.8

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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)

3. Reinsurance

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

As of January 1, 2008, the Pooling Arrangement was changed to add Beacon National, Patrons Mutual and Litchfield as participants and to add the middle market business of State Auto Mutual and Meridian Security to the Pooling Arrangement.

In conjunction with the Pooling Arrangement amendment, the STFC Pooled Companies received $92.0 million in cash, for additional net insurance liabilities assumed on January 1, 2008. The following table presents the impact on the Company s balance sheet on January 1, 2008, relative to the additional net insurance liabilities assumed on this date.

($ millions)	
Losses and loss expense payable	$ 51.3
Unearned premiums	53.6
Deferred policy acquisition costs	(12.9)
Net cash received	$ 92.0

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

($ millions)	Three months ended September 30		Nine months ended September 30	
	2008	2007	**2008**	2007
Premiums earned:				
Assumed from other insurers and reinsurers	**$ 1.6**	1.6	**$ 4.3**	4.7
Assumed under State Auto Pool and other affiliate arrangements	**270.1**	241.3	**808.7**	724.9
Ceded to other insurers and reinsurers	**(6.7)**	(5.6)	**(16.3)**	(14.6)
Ceded under State Auto Pool and other affiliate arrangements	**(175.4)**	(174.1)	**(522.2)**	(520.6)
Net assumed premiums earned	**$ 89.6**	63.2	**$ 274.5**	194.4

Losses and loss expenses incurred:				
Assumed from other insurers and reinsurers	**$ 0.6**	0.9	**$ 1.9**	1.0
Assumed under State Auto Pool and other affiliate arrangements	**224.1**	156.7	**655.1**	443.5
Ceded to other insurers and reinsurers	**(18.5)**	(0.8)	**(20.1)**	(2.6)
Ceded under State Auto Pool and other affiliate arrangements	**(126.7)**	(115.4)	**(421.4)**	(315.9)
Net assumed losses and loss expenses incurred	**$ 79.5**	41.4	**$ 215.5**	126.0

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

4. Pension and Postretirement Benefit Plans

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

($ millions)	Pension		Postretirement		Pension		Postretirement	
	Three months ended September 30				Nine months ended September 30			
	2008	2007	**2008**	2007	**2008**	2007	**2008**	2007
Service cost	**$ 2.2**	2.3	**$ 1.3**	1.4	**$ 6.6**	6.8	**$ 3.9**	4.2
Interest cost	**3.4**	3.1	**1.9**	1.8	**10.2**	9.3	**5.7**	5.4
Expected return on plan assets	**(4.8)**	(4.5)			**(14.4)**	(13.5)		(0.1)
Amortization of prior service costs	**0.1**	0.1	**0.1**	0.1	**0.3**	0.3	**0.3**	0.3
Amortization of transition assets	**(0.2)**	(0.2)			**(0.6)**	(0.5)		
Amortization of net loss	**0.7**	1.0		0.2	**2.1**	3.0		0.6
Net periodic cost	**$ 1.4**	1.8	**$ 3.3**	3.5	**$ 4.2**	5.4	**$ 9.9**	10.4

The Company expects to contribute $12.0 million to its pension plan during 2008. For the three and nine months ended September 30, 2008, the Company has contributed $4.0 million and $8.0 million, respectively in cash to its pension plan.

5. (Loss) Earnings per Common Share

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

($ millions, except per share amounts)	Three months ended September 30		Nine months ended September 30	
	2008	2007	**2008**	2007
Numerator:				
Net (loss) income for basic earnings per share	**$ (14.7)**	23.2	**$ (30.5)**	77.4
Denominator:				
Basic weighted average shares outstanding	**39.5**	41.2	**39.7**	41.1
Effect of dilutive share-based awards		0.5		0.7
Diluted weighted average shares outstanding	**39.5**	41.7	**39.7**	41.8
Basic (loss) earnings per share	**$ (0.37)**	0.56	**$ (0.77)**	1.88

Diluted (loss) earnings per share	**$ (0.37)**	0.55	**$ (0.77)**	1.86

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

(number of options in millions)	Three months ended September 30		Nine months ended September 30	
	2008	2007	**2008**	2007
Number of options	**1.4**	1.1	**1.4**	0.3

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

6. Comprehensive (Loss) Income

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

($ millions)	Three months ended September 30		Nine months ended September 30	
	2008	2007	**2008**	2007
Net (loss) income	**$ (14.7)**	23.2	**$ (30.5)**	77.4
Other comprehensive (loss) income:				
Change in unrealized holding (loss) gains, net of tax	**(39.6)**	10.2	**(76.8)**	(4.1)
Amortization of gain on derivative used in cash flow hedge		(0.1)		(0.1)
Amortization of pension and postretirement benefit obligations, net of tax	**0.5**	0.2	**1.4**	0.6
Other comprehensive (loss) income	**(39.1)**	10.3	**(75.4)**	(3.6)
Comprehensive (loss) income	**$ (53.8)**	33.5	**$ (105.9)**	73.8

7. Segment Information

The Company has three significant reportable segments personal insurance, business insurance, and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments operate in 33 states and distribute their products through our independent insurance agency system. The personal insurance segment provides primarily personal auto (standard and nonstandard) and homeowners to the personal insurance market. The business insurance segment provides primarily commercial auto, commercial multi-peril, fire and allied lines, other and product liability and workers compensation insurance to small-to-medium sized businesses within the commercial insurance market. The Company s investable assets, the investment operations segment, are managed by Stateco Financial Services, Inc (Stateco), a wholly owned subsidiary. The Company s investment portfolio is comprised primarily of publicly traded fixed income and equity securities.

The Company evaluates the performance of its insurance segments using industry financial measurements determined based on Statutory Accounting Principles (SAP), which include loss and loss adjustment expense ratios, underwriting expense ratios, combined ratios, statutory underwriting gain (loss), net premiums earned and net premiums written. The most significant difference between SAP and Generally Accepted Accounting Principles (GAAP) is that SAP requires all underwriting expenses to be expensed immediately and not deferred 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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The following table provides financial information regarding the Company s reportable segments for the periods ended September 30:

($ millions)	Three months ended September 30		Nine months ended September 30	
	2008	2007	**2008**	2007
Revenues from external sources:				
Insurance segments				
Personal insurance	**$ 167.6**	152.4	**$ 499.6**	456.6
Business insurance	**113.1**	99.7	**341.4**	300.7
Total insurance segments	**280.7**	252.1	**841.0**	757.3
Investment operations segment				
Net investment income	**23.0**	21.1	**67.7**	63.0
Realized (losses) capital gains	**(4.3)**	6.4	**(3.7)**	11.1
Total investment operations segment	**18.7**	27.5	**64.0**	74.1
All other	**1.2**	1.3	**3.6**	3.7
Total revenues from external sources	**300.6**	280.9	**908.6**	835.1
Intersegment revenues	**(2.4)**	2.3	**(7.3)**	7.0
Total revenues	**298.2**	283.2	**901.3**	842.1
Reconciling items:				
Intersegment expenses	**2.4**	(2.3)	**7.3**	(7.0)
Total consolidated revenues	**$ 300.6**	280.9	**$ 908.6**	835.1
Segment (loss) income before federal income tax:				
Insurance segments:				
Personal insurance SAP underwriting (loss) gain	**$ (31.6)**	0.8	**$ (78.4)**	22.5
Business insurance SAP underwriting (loss) gain	**(14.3)**	5.9	**(53.3)**	21.5
Total insurance segments	**(45.9)**	6.7	**(131.7)**	44.0
Investment operations segment:				
Net investment income	**23.0**	21.1	**67.7**	63.0
Realized capital (losses) gains	**(4.3)**	6.4	**(3.7)**	11.1
Total investment operations segment	**18.7**	27.5	**64.0**	74.1
All other segments	**(0.5)**	(0.6)	**(1.4)**	(2.0)

Total segment (loss) income before taxes	**(27.7)**	33.6	**(69.1)**	116.1
Reconciling items:				
GAAP expense adjustments	**(0.3)**	(2.2)	**7.1**	(10.2)
Interest expense on corporate debt	**(1.8)**	(1.9)	**(5.5)**	(5.6)
Corporate expenses	**(0.4)**	(0.9)	**(1.9)**	(2.0)
Total consolidated (loss) income before federal income taxes	**$ (30.2)**	28.6	**$ (69.4)**	98.3

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Revenues from external sources for reportable segments include the following products and services for the period ended September 30:

($ millions)	Three months ended September 30		Nine months ended September 30	
	2008	2007	**2008**	2007
Revenues from significant reportable segments:				
Insurance Segments Premiums earned:				
Standard personal auto	**$ 96.9**	89.7	**$ 285.3**	267.6
Nonstandard personal auto	**10.7**	10.7	**32.3**	32.3
Homeowners	**53.0**	46.3	**160.8**	139.6
Other personal	**7.0**	5.7	**21.2**	17.1
Total personal insurance	**167.6**	152.4	**499.6**	456.6
Commercial auto	**27.7**	24.1	**83.0**	72.9
Commercial multi-peril	**24.3**	21.6	**73.7**	65.1
Fire & allied lines	**23.0**	20.7	**70.6**	61.9
Other & product liability	**20.0**	18.7	**60.4**	56.8
Workers compensation	**11.1**	8.1	**32.2**	24.7
Other business	**7.0**	6.5	**21.5**	19.3
Total business insurance	**113.1**	99.7	**341.4**	300.7
Total premiums earned	**280.7**	252.1	**841.0**	757.3
Net investment income	**23.0**	21.1	**67.7**	63.0
Realized capital (losses) gains	**(4.3)**	6.4	**(3.7)**	11.1
Total investment operations	**18.7**	27.5	**64.0**	74.1
Total revenues from significant reportable segments	**$ 299.4**	279.6	**$ 905.0**	831.4

Investable assets attributable to the Company s investment operations segment totaled $2,074.1 million at September 30, 2008 and $2,092.1 million at December 31, 2007.

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8. Contingencies and Litigation

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

In accordance with the provisions of SFAS No. 5, Accounting for Contingencies, the Company accrues for a litigation-related liability other than insurance claims when it is probable that such a liability has been incurred and the amount of the loss can be reasonably estimated. Based on currently available information known to the Company, the Company believes that its reserves for these litigation-related liabilities are reasonable and that the ultimate outcomes of any pending matters are not likely to have a material adverse effect on its consolidated financial position or results of operations.

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

9. Income Taxes

Loss before federal income taxes for the three and nine months ended September 30, 2008 was $30.2 million and $69.4 million, respectively, compared to income of $28.6 million and $98.3 million, respectively, for the same 2007 periods. The pre-tax losses for the third quarter and the first nine months of 2008, were primarily the result of significant increases in catastrophe storm losses compared to the same 2007 periods. The uncertainty of our expected 2008 full year results precludes us from making a reliable estimate of the effective tax rate for the year. Accordingly, the Company recorded a tax benefit for the results of the nine months ended September 30, 2008. The effective tax rate for the three and nine months ended September 30, 2007 was 19.0% and 21.3%, respectively, which also reflects the impact of tax exempt investment income.

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10. Subsequent events

Employee Benefit Plans

In October 2008, the Company announced a substantive change to increase retiree cost sharing within the postretirement medical plan, effective January 1, 2009. This change will allow the Company to manage its overall company costs and continue to provide a competitive retiree medical plan for all associates and current retirees. The increase will be phased in over five years for current retirees and those associates who announce their retirement before the end of the year and retire in the first half of 2009.

The following table provides the incremental effect on the Company s balance sheet at October 1, 2008, for remeasurement of the postretirement benefit obligation for this cost sharing change:

($ millions)	September 30 2008	Effect of Remeasurement	October 1 2008
Assets:			
Deferred federal income taxes	$ 94.2	(18.0)	76.2
Liabilities:			
Postretirement benefits	$ 128.8	(45.0)	83.8
Stockholder s Equity:			
Accumulated other comprehensive loss	$ (75.3)	27.0	(48.3)

In October 2008, the Company offered an early retirement incentive option to retirement eligible associates. This early retirement option is deemed a special termination benefit under SFAS No. 88 Employers Accounting for Settlements and Curtailments of Define Benefit Pension Plans and for Termination Benefits. An employer offering special termination benefits to employees must recognize a liability and an expense when the following conditions are met: 1) the employees accept the offer, and 2) the amount can be reasonably estimated. The Company will recognize an expense during the fourth quarter 2008 for the acceleration of certain benefits for those retirement eligible associates who elect early retirement. The Company has estimated this expense to be up to $4.0 million depending on the number who elect to participate.

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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 ou 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. The term SAP as used below refers to Statutory Accounting Principles and the term GAAP as used below refers to U.S. Generally Accepted Accounting Principles.

The discussion and analysis presented below relates to the material changes in financial condition and results of operations for our consolidated balance sheets as of September 30, 2008 and December 31, 2007, and for the consolidated statements of income for the three-month and nine-month periods ended September 30, 2008 and 2007. This discussion and analysis should be read together with Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for our year ended December 31, 2007 (the 2007 Form 10-K), and in particular the discussions in those sections thereof entitled Executive Summary and Critical Accounting Policies. Readers are encouraged to review the entire 2007 Form 10-K, as it includes information regarding our Company not discussed in this Form 10-Q. This information will assist in your understanding of the discussion of our current period financial results.

The discussion and analysis presented below includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements generally can be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, project, believe or continue or the neg variations thereon or similar terminology. Forward-looking statements speak only as of the date the statements were made. Although we believe that the expectations reflected in forward-looking statements have a reasonable basis, we can give no assurance that these expectations will prove to be correct. Forward-looking statements are subject to risks and uncertainties that could cause actual events or results to differ materially from those expressed in or implied by the statements. For a discussion of the most significant risks and uncertainties that could cause our actual results to differ materially from those projected, see Risk Factors in Item 1A of the 2007 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.

We have three significant reportable segments personal insurance, business insurance, and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments operate in 33 states and distribute their products through the independent insurance agency system. The personal insurance segment provides primarily personal auto (standard and nonstandard) and homeowners insurance to the personal insurance market. The business insurance segment provides primarily commercial auto, commercial multi-peril, fire and allied lines, other and product liability and workers compensation insurance to small-to-medium sized businesses within the commercial insurance market. Our investable assets, the investment operations segment, are managed by our subsidiary Stateco Financial Services, Inc (Stateco). The Company s investment portfolio is comprised primarily of publicly traded fixed income and equity securities. Financial information about our segments is set forth in Note 7 of our Condensed Consolidated Financial Statements included in Item 1 of this Form 10-Q.

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

As of January 1, 2008, the Pooling Arrangement was changed (the Pooling Change) to add Beacon National, Patrons Mutual and Litchfield as participants and to add the middle market business of State Auto Mutual and Meridian Security to the Pooling Arrangement (collectively referred to as the New Pool Business). In conjunction with the Pooling Change, the STFC Pooled Companies received $92.0 million in cash related to the additional net insurance liabilities assumed on January 1, 2008.

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The following table presents the impact on our balance sheet on January 1, 2008, relating to the Pooling Change:

($ millions)	
Losses and loss expense payable	$ 51.3
Unearned premiums	53.6
Deferred policy acquisition costs	(12.9)
Net cash received	$ 92.0

The following table sets forth a chronology of the participants and participation percentages for the Pooling Arrangement:

	2007	2008
STFC Pooled Companies:		
State Auto P&C	59.0%	59.0%
Milbank	17.0	17.0
Farmers	3.0	3.0
SA Ohio	1.0	1.0
Subtotal	80.0	80.0
Mutual Pooled Companies:		
State Auto Mutual	19.5	19.0
SA Wisconsin	0.0	0.0
SA Florida	0.0	0.0
Meridian Security	0.0	0.0
Meridian Citizens Mutual	0.5	0.5
Beacon National	N/A	0.0
Patrons Mutual	N/A	0.4
Litchfield	N/A	0.1
Subtotal	20.0	20.0

The Pooled Companies and State Auto National Insurance Company (SA National) are collectively referred to herein as the State Auto Group.

ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158) that requires employers of defined benefit pension and postretirement benefit plans other than pensions (collectively benefit plans) to recognize the funded status of their benefit plans in their balance sheet, measure the fair value of plan assets and benefit obligations as of the date of the year-end balance sheet date thereby eliminating the use of an earlier measurement date and provide additional disclosures. The new measurement date requirement was not effective until fiscal years ending after December 15, 2008. The Company adopted the recognition and disclosures provision on December 31,

2006. Effective January 1, 2008, the Company adopted the measurement date requirement under transition alternative method one, as defined in SFAS 158. This transition method resulted in a one-time adjustment that decreased beginning retained earnings by $2.4 million, net of tax. The combined impact of measurement date transition and re-measurement of plan assets and obligations on January 1, 2008, increased beginning accumulated comprehensive income by $3.5 million, net of tax.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. The Statement imposes no new requirements for additional fair-value measures in financial statements. The Company adopted the provisions of SFAS 157 on January 1, 2008. The adoption of SFAS 157 did not require any adjustments to the Company s previously reported financial statements.

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In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 expands the standards under SFAS 157 to provide entities a one-time election to measure financial instruments and certain other items at fair value. SFAS 159 also amends SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities to require a specific presentation of investments categorized as available-for-sale. This Statement is effective for the first year that begins after November 15, 2007. The Company adopted this guidance effective January 1, 2008 and did not elect the fair value option for any of its eligible assets or liabilities as of that date.

RESULTS OF OPERATIONS

During the three and nine months ended September 30, 2008, we recognized a net loss of $14.7 million and $30.5 million, respectively, compared to net income of $23.2 million and $77.4 million, respectively for the same 2007 periods. Loss before federal income taxes for the three and nine months ended September 30, 2008 was $30.2 million and $69.4 million, respectively, compared to income before federal income taxes of $28.6 million and $98.3 million, respectively for the same 2007 periods. Our pre-tax loss for the three and nine months ended September 30, 2008 was primarily driven by the following factors:

- Catastrophe losses for the three months ended September 30, 2008 were $54.7 million or 19.5 loss ratio points compared to $14.1 million or 5.6 loss ratio points for the same 2007 period.

  While Hurricane Ike caused serious damage in Texas, most of our significant losses from this hurricane occurred in Ohio, Kentucky and Indiana when Hurricane Ike delivered tropical storm-force winds to parts of the Midwest. Hurricane Ike accounted for $45.2 million of losses or 16.1 loss ratio points for the three months ended September 30, 2008. This amount is net of estimated recoveries under our catastrophe reinsurance program.

- Catastrophe losses for nine months ended September 30, 2008, were $166.5 million, or 19.8 loss ratio points, compared to $43.0 million, or 5.7 loss ratio points, for the same 2007 period.

  To date ISO s Property Claim Services (PCS) unit, a nationally recognized industry service has identified 36 numbered catastrophes for the first nine months of 2008. We experienced losses from 34 of these 36 classified catastrophes, as compared to 18 for all of 2007. Hurricane Ike accounted for 5.4 loss ratio points of the 19.8 loss ratio points.

- Impacting both our 2008 quarter and year to date written and earned premiums were the following:

  As of July 1, 2008, we terminated our State Auto P&C intercompany catastrophe reinsurance agreement, which resulted in $0.8 million less net written and earned premiums within our property lines for the three and nine months ended September 30, 2008 when compared to the same 2007 periods.
  Our third party catastrophe reinsurance program, which renewed July 1, 2008 (coverage period July 1, 2008 through June 30, 2009), incorporates a reinstatement provision should a loss occurrence exceed our retention. Under this provision, our original reinsurance coverage limits are automatically restored in consideration of an additional reinstatement premium

(the Reinstatement Premium). The estimated ultimate loss resulting from Hurricane Ike exceeded our retention thereby causing two premium transactions to occur: 1) an acceleration of the recognition of the original annual premium to the date of loss occurrence in proportion to the reinsurance coverage exhausted and 2) the recognition of the Reinstatement Premium from the date of the loss occurrence to the end of the coverage period (June 30, 2009). The incremental impact of acceleration of the original annual premium plus the recognition Reinstatement Premium was $2.7 million during the third quarter. The incremental impact has the most significant effect on our property lines (homeowners $1.2 million, fire & allied lines $0.8 million and commercial multi-peril $0.4 million).

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- During the three and nine months ended September 30, 2008, we recognized other-than-temporary impairments within our equity portfolio of $5.9 million and $9.6 million, respectively. See our detailed discussion in the Investment Operations Segment of this Form 10-Q.

The following table summarizes certain key performance metrics for the three and nine months ended September 30, 2008 and 2007 that we use to monitor our financial performance:

($ millions, except per share amounts)	Three months ended September 30		Nine months ended September 30	
GAAP Basis:	**2008**	2007	**2008**	2007
Total revenue	**$ 300.6**	280.9	**$ 908.6**	835.1
Net (loss) income	**$ (14.7)**	23.2	**$ (30.5)**	77.4
Stockholders equity	**$ 787.8**	898.5		
Book value per share	**$ 19.94**	21.85		
Loss and LAE ratio[1]	**82.4%**	65.3%	**81.1%**	61.8%
Expense ratio[1]	**33.8%**	32.7%	**33.4%**	33.5%
Combined ratio[1]	**116.2%**	98.0%	**114.5%**	95.3%
Catastrophe loss and LAE ratio	**19.5%**	5.6%	**19.8%**	5.7%
Premium written growth[2]	**13.5%**	(0.6%)	**18.8%**	(0.4%)
Premium earned growth	**11.3%**	(1.4%)	**11.1%**	(1.5%)
Investment yield	**4.3%**	4.3%	**4.2%**	4.3%

	Three months ended September 30		Nine months ended September 30	
SAP Basis:	**2008**	2007	**2008**	2007
Loss and LAE ratio[3]	**82.0%**	64.8%	**80.7%**	61.3%
Expense ratio[3]	**32.4%**	31.3%	**31.8%**	32.0%
Combined ratio[3]	**114.4%**	96.1%	**112.5%**	93.3%

	Twelve months ended September 30	
	2008	2007
Net premiums written to surplus[4]	**1.4**	1.1

(1) Defined below.

(2) 6.9 points of the percentage increase for the nine months ended September 30, 2008 related to the one-time $53.6 million transfer of unearned premium to us on January 1, 2008, in conjunction with the Pooling Change.

(3) The SAP Loss and LAE Ratio is losses and loss expenses as a percentage of net earned premiums. The SAP Expense Ratio is statutory underwriting expenses and miscellaneous expenses offset by miscellaneous income (underwriting expenses) as a percentage of net written premiums. The SAP Combined Ratio is the sum of the SAP Loss and LAE Ratio and the SAP Expense Ratio.

(4) We use the statutory net premiums written to surplus ratio as there is no comparable GAAP measure. This ratio, also called the leverage ratio, measures a company s statutory surplus available to absorb losses.

Insurance Segments

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

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measures used are loss and LAE ratios, underwriting expense ratio, combined ratio, net written premiums and net earned premiums. The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio. When the combined ratio is less than 100%, the insurer is operating at an underwriting gain and when it is greater than 100%, the insurer is operating at an underwriting loss. Underwriting gain (loss) is determined by subtracting from net earned premiums, the amount of losses and loss expenses and underwriting expenses.

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred policy acquisition costs see Critical Accounting Policies Deferred Acquisition Costs included in Item 7 of our 2007 Form 10-K. The GAAP Loss and LAE Ratio is losses and loss expenses as a percentage of earned premiums. The GAAP Expense Ratio is acquisition and operating expenses as a percentage of earned premiums. The GAAP Combined Ratio is the sum of the GAAP Loss and LAE Ratio plus the GAAP Expense Ratio.

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

The following tables provide a summary of our insurance segments SAP underwriting gain and SAP Combined Ratio for the three and nine months ended September 30, 2008 and 2007:

($ millions)

	Three months ended September 30, 2008					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Net written premiums	**$ 183.2**		**$ 114.6**		**$ 297.8**	
Net earned premiums	**167.6**		**113.1**		**280.7**	
Losses and loss expenses	**144.8**	**86.4**	**85.4**	**75.5**	**230.2**	**82.0**
Underwriting expenses	**54.4**	**29.7**	**42.1**	**36.7**	**96.5**	**32.4**
SAP underwriting loss and SAP Combined Ratio	**$ (31.6)**	**116.1**	**$ (14.4)**	**112.2**	**$ (46.0)**	**114.4**

($ millions)

	Three months ended September 30, 2007					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Net written premiums	$ 162.4		$ 100.0		$ 262.4	
Net earned premiums	152.4		99.7		252.1	
Losses and loss expenses	105.5	69.2	57.8	58.0	163.3	64.8
Underwriting expenses	46.1	28.4	36.0	36.0	82.1	31.3

SAP underwriting gain and SAP Combined Ratio	$ 0.8	97.6	$ 5.9	94.0	$ 6.7	96.1	

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($ millions)

	Nine months ended September 30, 2008					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Net written premiums [1]	**$ 544.8**		**$ 378.9**		**$ 923.7**	
Net earned premiums	**499.6**		**341.4**		**841.0**	
Losses and loss expenses	**423.4**	**84.7**	**255.2**	**74.8**	**678.6**	**80.7**
Underwriting expenses	**154.6**	**28.4**	**139.5**	**36.8**	**294.1**	**31.8**
SAP underwriting loss and SAP Combined Ratio	**$ (78.4)**	**113.1**	**$ (53.3)**	**111.6**	**$ (131.7)**	**112.5**

($ millions)

	Nine months ended September 30, 2007					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Net written premiums	$ 466.8		$ 310.7		$ 777.5	
Net earned premiums	456.6		300.7		757.3	
Losses and loss expenses	299.1	65.5	164.9	54.8	464.0	61.3
Underwriting expenses	135.1	28.9	114.3	36.8	249.4	32.0
SAP underwriting gain and SAP Combined Ratio	$ 22.5	94.4	$ 21.5	91.6	$ 44.0	93.3

[1] Includes the one-time transfer of $53.6 million of unearned premiums to us on January 1, 2008, in conjunction with the Pooling Change ($24.8 million for our personal insurance segment and $28.8 million for our business insurance segment).

Revenue

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

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The following table shows the one-time impact on net written premiums for the nine months ended September 30, 2008 of the unearned premiums transferred to us on January 1, 2008, in conjunction with the Pooling Change.

($ millions)	Net Written Premiums Including Pooling Change	Pooling Change Impact	Excluding Pooling Change
Personal insurance segment:			
Standard auto	$ 305.7	$ 7.9	$ 297.8
Nonstandard auto	33.3		33.3
Homeowners	181.3	14.4	166.9
Other personal	24.5	2.5	22.0
Total personal	544.8	24.8	520.0
Business insurance segment:			
Commercial auto	92.9	10.0	82.9
Commercial multi-peril	82.3	6.1	76.2
Fire & allied lines	77.5	5.7	71.8
Product & other liability	65.9	3.9	62.0
Workers compensation	36.8	2.0	34.8
Other business	23.5	1.1	22.4
Total business	378.9	28.8	350.1
Total personal & business	$ 923.7	$ 53.6	$ 870.1

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Personal Insurance Segment Revenue

Our personal insurance segment consists primarily of auto (standard and nonstandard) and homeowners products, with personal auto representing 38.1% of our total consolidated net written premiums.

The following table provides a summary of written and earned premium, net of reinsurance, by major product line of business for our personal insurance segment for 2008 and 2007 (the one-time impact of the Pooling Change has been excluded from the nine months ended September 30, 2008 to present net written premiums on a comparative basis):

($ millions)	Three months ended September 30			Nine months ended September 30		
	2008	2007	% Change	**2008**	2007	% Change
	Net Written Premiums					
Personal insurance segment:						
Standard Auto	**$ 103.8**	92.9	11.7	**$ 297.8**	272.7	9.2
Nonstandard Auto	**10.8**	11.1	(2.7)	**33.3**	33.4	(0.3)
Homeowners	**61.3**	52.6	16.5	**166.9**	143.2	16.6
Other personal	**7.3**	5.8	25.9	**22.0**	17.5	25.7
Total personal	**$ 183.2**	162.4	12.8	**$ 520.0**	466.8	11.4
	Net Earned Premiums					
Personal insurance segment:						
Standard auto	**$ 96.9**	89.7	8.0	**$ 285.3**	267.6	6.6
Nonstandard auto	**10.7**	10.7		**32.3**	32.3	
Homeowners	**53.0**	46.3	14.5	**160.8**	139.6	15.2
Other personal	**7.0**	5.7	22.8	**21.2**	17.1	24.0
Total personal	**$ 167.6**	152.4	10.0	**$ 499.6**	456.6	9.4

For the third quarter 2008, the personal insurance net written premium increased 12.8% from the same 2007 period, with 7.0% of this increase attributed to the New Pool Business and 5.8% of this attributed to Organic Growth. We define Organic Growth in this Form 10-Q as premium growth excluding premium growth related to the New Pool Business. In total, the personal insurance segment net written premium for the first nine months of 2008 increased 11.4% from the same 2007 period, with 7.0% of this increase attributed to the New Pool Business and 4.4% of this attributed to Organic Growth.

Our Organic Growth for net written premiums has been impacted by our decision in 2007 to withdraw our personal insurance products from Florida as of January 1, 2008. The net written premium loss from this action was $3.1 million and $9.7 million for the three and nine months ended September 30, 2008, respectively.

Standard personal auto net written premiums increased 11.7% and 9.2% for the three and nine months ended September 30, 2008, respectively, from the same 2007 periods. The increases are attributed to the New Pool Business and Organic Growth. The New Pool Business contributed 3.7% and 4.1% for the three and nine months ended September 30, 2008, respectively, while Organic Growth increased 8.0% and 5.1% for the same respective periods.

The primary product contributing to our increase in Organic Growth in standard personal auto is our CustomFit[SM] product which uses a multivariate rating approach that broadens the underwriting and eligibility guidelines for new customers. We have distributed this product in 24 of our 33 operative states since 2005 and subsequently have seen significant improvements in our net written premiums production trends for new business. In late 2007, we introduced the second generation of CustomFit[SM] into its first state. This second generation product includes approximately 1,000 additional price points to further improve rating sophistication. During 2008, we continued migrating CustomFit[SM] states to the second generation product.

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We believe independent agents value ease of doing business and make it an important factor in their choice of insurance companies when quoting personal auto products to their customers. To assist in this area, in early 2007, we began implementing comparative rating tools which allow agents to receive rate quotes from multiple insurance companies by entering the rating information only one time. To date, we have implemented 65 different integration points to our personal lines rating engine thus eliminating duplicate entry for agents. We believe agents will quote and write more personal standard and nonstandard auto, and homeowners, with us as a result of a more efficient quoting process combined with more competitive rates resulting from the ongoing introduction of CustomFit[SM] for standard auto and refined pricing for nonstandard auto.

Nonstandard auto net written premium decreased 2.7% and 0.3% for the three and nine months ended September 30, 2008, respectively, from the same 2007 periods. These decreases are the result of implementing agressive rate actions, improving our agency mix, and tightening underwriting controls to improve profit. As a result of these recent actions, we have experienced a gradual improvement in our underwriting results. See SAP Loss and LAE Ratios Table in the Losses and Expenses section included herein.

Homeowners net written premium increased 16.5% and 16.6% in the three and nine months ended September 30, 2008, respectively, from the same 2007 periods. The New Pool Business contributed 12.3% and 12.8% for the three and nine months ended September 30, 2008, while Organic Growth increased 4.2% and 3.8% for the respective periods. We have undertaken new homeowners pricing and product initiatives, such as various new home discounts that complement our CustomFit[SM] automobile rollout, in order to improve our premium growth.

Our strategy to grow our personal lines business includes introducing our products, enhanced systems and easier technologies into new states. During 2008, we began introducing our personal lines products and technologies into Texas through the independent agent distribution channel as a result of State Auto Mutual s acquisition of Beacon National in early 2007. In addition, future plans include leveraging our relationship with the Patrons Mutual agency distribution channel to add upgraded product lines and technologies into Connecticut.

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Business Insurance Segment Revenue

We focus our business insurance sales on small-to-medium sized businesses within the commercial insurance market and offer a broad range of both property and liability coverages such as commercial auto, commercial multi-peril, fire and allied lines, other and products liability and workers compensation.

The following table provides a summary of written and earned premiums, net of reinsurance, by major product line for our business insurance segment for 2008 and 2007 (the one-time impact of the Pooling Change has been excluded from the nine months ended September 30, 2008 to present net written premiums on a comparative basis):

($ millions)	Three months ended September 30			Nine months ended September 30		
	2008	2007	% Change	**2008**	2007	% Change
	Net Written Premiums					
Business insurance segment:						
Commercial auto	**$ 27.0**	22.7	18.9	**$ 82.9**	74.4	11.4
Commercial multi-peril	**25.0**	21.9	14.2	**76.2**	66.2	15.1
Fire & allied lines	**24.5**	21.9	11.9	**71.8**	63.2	13.6
Other & product liability	**19.4**	17.8	9.0	**62.0**	58.8	5.4
Workers compensation	**12.1**	9.1	33.0	**34.8**	27.6	26.1
Other commercial	**6.6**	6.6		**22.4**	20.5	9.3
Total business	**$ 114.6**	100.0	14.6	**$ 350.1**	310.7	12.7
	Net Earned Premiums					
Business insurance segment:						
Commercial auto	**$ 27.7**	24.1	14.9	**$ 83.0**	72.9	13.9
Commercial multi-peril	**24.3**	21.6	12.5	**73.7**	65.1	13.2
Fire & allied lines	**23.0**	20.7	11.1	**70.6**	61.9	14.1
Other & product liability	**20.0**	18.7	7.0	**60.4**	56.8	6.3
Workers compensation	**11.1**	8.1	37.0	**32.2**	24.7	30.4
Other commercial	**7.0**	6.5	7.7	**21.5**	19.3	11.4
Total business	**$ 113.1**	99.7	13.4	**$ 341.4**	300.7	13.5

The business insurance segment net written premium increased 14.6% and 12.7% for the three and nine months ended September 30, 2008, respectively, from the same 2007 periods. The increase is attributed to the New Pool Business and Organic Growth. The New Pool Business contributed 13.9% and 12.0% for the three and nine months ended September 30, 2008, respectively, while Organic Growth increased 0.7% for each of the respective periods. Business insurance continues to be impacted by rate competition as well as ease of doing business issues. We are seeking to balance our traditional underwriting discipline with new products and pricing tools that support the production of profitable new business.

We continue to invest in products, processes and systems that we believe will increase our business insurance writings. We have expanded our marketability by introducing new products, enhancing existing products and broadening eligibility. For our property and liability business, we have also implemented a more granular pricing process that we believe will help us price risks more accurately and improve account retention; we are pursuing the same for our commercial auto and workers compensation lines of business. In addition, we have broadened our property, liability, auto and workers compensation pricing ranges to better recognize better the spectrum of risks within our markets. This year, we introduced an enhanced Employment Practices Liability product to agents in all states, except Virginia, and added enhanced functionality for agents to perform more detailed loss analysis on their existing book of business insurance policies.

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We also continue to enhance our back office systems, which makes it easier for agents to quote and submit business insurance accounts. Leveraging real-time and straight through processing functionality, we introduced bizXpress[SM], our web-based quote and issuance system for business owners policies in 2007, and we expanded its functionality to include commercial auto risks in all states this year.

Similar to our personal lines segment, we are leveraging our relationship with the agency distribution channel as a result of State Auto Mutual s acquisition of Beacon National in early 2007. During the fourth quarter of 2007 we introduced our business product portfolio in Texas. In addition, we plan to leverage our relationship with the Patrons Mutual agency distribution channel to add upgraded business insurance product lines and new systems into Connecticut. We have begun introducing State Auto commercial products to our Connecticut agents. We have already introduced our commercial auto product to this market and plan to introduce workers compensation and other commercial products in the near future.

Losses and Expenses

Our GAAP Loss and LAE ratio was 82.4% and 81.1% for the three and nine months ended September 30, 2008, respectively, as compared to 65.3% and 61.8% for the same 2007 periods, respectively. The increase in the GAAP Loss and LAE Ratios were primarily due to the catastrophe storm losses for both our personal and business insurance segments. For the third quarter 2008, we also experienced an increase in bodily injury severity of claims within our standard auto business. In addition, we incurred increased large loss activity in other and products liability and commercial auto liability, while our large loss activity within our commercial multi peril line improved for the quarter.

Catastrophe losses for the three and nine months ended September 30, 2008 totaled $54.7 million (19.5 loss ratio points) and $166.5 million (19.8 loss ratio points), respectively, compared to $14.2 million (5.6 loss ratio points) and $43.0 million (5.7 loss ratio points), respectively, for the same 2007 periods. During the three months ended September 30, 2008, the Company experienced losses from 10 different storms that were classified as numbered catastrophes by PCS. PCS defines catastrophes as events resulting in $25.0 million or more in insured losses industry-wide and affecting significant numbers of insureds and insurers. The losses from these catastrophes have had a significant impact on both our personal and business insurance property lines.

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The following table provides our insurance segments comparative SAP Loss and LAE Ratios by major line of business for 2008 and 2007:

	SAP Loss and LAE Ratios					
	Three months ended September 30			Nine months ended September 30		
	2008	2007	Increase (Decrease)	**2008**	2007	Increase (Decrease)
Personal insurance segment:						
Standard auto	**66.6**	58.2	8.4	**68.0**	60.5	7.5
Nonstandard auto	**57.2**	62.2	(5.0)	**72.8**	63.2	9.6
Homeowners	**126.0**	90.1	35.9	**116.3**	77.7	38.6
Other personal	**105.1**	85.9	19.2	**89.7**	48.8	40.9
Total personal	**86.4**	69.2	17.2	**84.7**	65.5	19.2
Business insurance segment:						
Commercial auto	**68.7**	53.6	15.1	**62.5**	50.9	11.6
Commercial multi-peril	**71.3**	82.0	(10.7)	**88.3**	66.0	22.3
Fire & allied lines	**98.4**	56.1	42.3	**97.5**	55.1	42.4
Other & product liability	**73.3**	45.1	28.2	**67.0**	43.5	23.5
Workers compensation	**82.2**	71.7	10.5	**66.1**	86.4	(20.3)
Other commercial	**37.9**	20.5	17.4	**35.5**	24.2	11.3
Total business	**75.5**	58.0	17.5	**74.7**	54.8	19.9
Total SAP personal & business	**82.0**	64.8	17.2	**80.7**	61.3	19.4

The personal insurance segment s SAP Loss and LAE Ratio for the three months ended September 30, 2008 increased 17.2 loss ratio points from the same 2007 period. Catastrophes accounted for 24.6 loss ratio points in the third quarter 2008 compared to 7.4 loss ratio points in the same 2007 period. Standard auto s SAP Loss and LAE Ratio increase can be attributed to higher catastrophe losses as well as an increase in both the number and the severity of bodily injury claims. The third quarter 2008 increase in the homeowners SAP Loss and LAE Ratio was entirely due to catastrophes. The homeowners non-catastrophe SAP Loss and LAE Ratio decreased 11.9 loss ratio points due to a decrease in non-catastrophe weather related losses when compared to the same 2007 period. Catastrophe losses accounted for approximately 64% of the increase in the other personal SAP Loss and LAE Ratio.

For the first nine months of 2008 the personal insurance segment SAP Loss and LAE Ratio increased 19.2 loss ratio points from the same 2007 period. Catastrophes accounted for 23.0 loss ratio points for the first nine months of 2008 compared to 7.9 loss ratio points for the same 2007 period. The non-catastrophe personal lines SAP Loss and LAE Ratio for the first nine months of 2008 was 4.2 loss ratio points higher than this ratio for the same 2007 period. The increase in the non-catastrophe standard auto SAP Loss and LAE Ratio of 5.5 loss ratio points was attributable to an increase in the severity of reported bodily injury and uninsured motorists claims and the establishment of reserves for the settlement of litigation in this line of business. This litigation and its ultimate settlement will not materially impact our operations. The increase of 8.6 loss ratio points in our non-catastrophe SAP Loss and LAE ratio for nonstandard auto was primarily the result of an increase in the frequency of claims.

The third quarter 2008 SAP Loss and LAE Ratio for the business insurance segment increased 17.5 loss ratio points from the same 2007 period primarily due to catastrophes, large loss activity, and competitive market conditions. Catastrophes accounted for 12.0 loss ratio points for the third quarter 2008 compared to 2.9 loss ratio points for the same 2007 period. Property lines were unfavorably impacted by catastrophes while

higher-than-normal other and products liability and other commercial liability large loss activity affected those lines. Fire & allied lines SAP Loss and LAE Ratio increased 34.4 loss ratio points due to the increased catastrophe activity in 2008 as compared to the same 2007 period. Commercial multi-peril non-catastrophe SAP Loss and LAE Ratio decreased 19.5 loss ratio points from the same 2007 period. Commercial auto s SAP non-catastrophe related SAP Loss and LAE Ratio increased 14.2 loss ratio points, due to an increase in the severity of large loss activity. The increase in the workers compensation SAP Loss and LAE ratio is due to an increase in the severity of claims.

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The business insurance segment s SAP and LAE Loss Ratio for the first nine months of 2008 increased 19.4 loss ratio points from the same 2007 period. Catastrophes accounted for 15.2 loss ratio points for the first nine months of 2008 compared to 2.3 loss ratio points for the first nine months of 2007. Commercial auto SAP Loss and LAE Ratio increased 11.6 loss ratio points to 62.5, mostly due to large loss activity. The increases in the commercial multi peril and fire & allied lines SAP Loss and LAE Ratio were nearly all driven by catastrophe losses. The increase in the other & product liability SAP Loss and LAE Ratio was related primarily to development of losses from prior accident years.

Loss and loss expenses payable by major line of business at September 30, 2008 and December 31, 2007, respectively, and at January 1, 2008 as a result of the Pooling Change, are shown in the following table:

($ millions)	**September 30, 2008**	December 31, 2007	January 1, 2008 [1]	$ Change [2]
Personal insurance segment:				
Standard auto	**$ 180.2**	169.1	177.9	$ 2.3
Nonstandard auto	**19.1**	18.3	18.3	0.8
Homeowners	**112.7**	53.4	62.5	50.2
Other personal	**17.1**	8.9	9.7	7.4
Total personal	**329.1**	249.7	268.4	60.7
Business insurance segment:				
Commercial auto	**93.3**	77.8	89.1	4.2
Commercial multi-peril	**99.8**	78.8	85.9	13.9
Fire & allied lines	**45.3**	20.3	21.9	23.4
Product & other liability	**151.9**	130.1	139.0	12.9
Workers compensation	**91.1**	85.5	88.7	2.4
Other business	**6.1**	4.9	5.4	0.7
Total business	**487.5**	397.4	430.0	57.5
Total losses and loss expenses payable net of reinsurance recoverable on losses and loss expenses payable	**$ 816.6**	647.1	698.4	118.2

(1) The December 31, 2007 loss and loss expenses payable balance has been adjusted for comparative purposes to reflect the loss and loss expenses payable assumed by us on January 1, 2008 from the Pooling Change.

(2) Calculated based on September 30, 2008 change from January 1, 2008.

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As shown in the table above, there was a $118.2 million increase in total loss and loss expense reserves during the nine months ended September 30, 2008. The increase relates primarily to property lines which were impacted by 2008 catastrophes for which claims are in the

settlement process but were not fully paid at September 30, 2008. We conduct periodic reviews of loss development reports and make judgments in determining the reserves for ultimate losses and loss expenses payable. Several factors are considered by us when estimating ultimate liabilities including consistency in relative case reserve adequacy, consistency in claims settlement practices, recent legal developments, historical data, actuarial projections, accounting projections, exposure changes, anticipated inflation, current business conditions, catastrophe developments, late reported claims, and other reasonableness tests.

The risks and uncertainties inherent in our estimates include, but are not limited to, actual settlement experience different from historical data, trends, changes in business and economic conditions, court decisions creating unanticipated liabilities, ongoing interpretation of policy provisions by the courts, inconsistent decisions in lawsuits regarding coverage and additional information discovered before settlement of claims. Our results of operations and financial condition could be impacted, perhaps significantly, in the future if the ultimate payments required to settle claims vary from the liability currently recorded. For a discussion of our reserving methodologies as well as a measure of sensitivity discussion see Management s Discussion and Analysis of Financial Condition and Results of Operations Other Loss and Loss Expense Reserves in Item 7 of the 2007 Form 10-K.

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The GAAP Expense Ratios were 33.8% and 33.4% for the three and nine months ended September 30, 2008, respectively. During 2007, the GAAP Expense Ratios for the three and nine months ended September 30, 2008, were 32.7% and 33.5%, respectively.

Investment Operations Segment

At September 30, 2008, all investments in fixed maturity and equity securities and certain other invested assets were held as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are included as a separate component of stockholders equity in accumulated other comprehensive loss and, as such, are not included in the determination of net income.

For further discussion regarding the management of our investment portfolio, see Management s Discussion and Analysis of Financial Condition and Results of Operations Results of Operations 2007 Compared to 2006 Investment Operations Segment in Item 7 of the 2007 Form 10-K.

Composition of Investment Portfolio

The following table provides the composition of our available-for-sale investment portfolio at fair value at September 30, 2008 and December 31, 2007, respectively:

($ millions)	**September 30, 2008**		December 31, 2007	
Fixed maturities	**$ 1,756.0**	**88.5%**	1,745.4	86.4
Equity securities	**191.7**	**9.7**	254.2	12.6
Other invested assets	**36.2**	**1.8**	20.3	1.0
Total available-for-sale investments	**$ 1,983.9**	**100.0%**	2,019.9	100.0

The amortized cost and fair value of fixed maturities at September 30, 2008, by contractual maturity, are as follows:

($ millions)	Amortized Cost	Fair Value
Due in 1 year or less	$ 7.4	7.4
Due after 1 year through 5 years	74.5	76.1
Due after 5 years through 10 years	398.4	405.4
Due after 10 years	1,153.1	1,091.8
Mortgage-backed securities	178.7	175.3
Total	$ 1,812.1	1,756.0

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.

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The following table provides a breakdown of our investment portfolio percentages by investment type at September 30, 2008 and December 31, 2007. Note that we measure our investment portfolio allocation with fixed maturities at amortized cost and equities at fair value.

($ in millions)	**September 30, 2008**	**% of Total**	December 31, 2007	% of Total
Core fixed maturities	**$ 1,740.7**	**81.7**	1,710.0	82.6
Treasury inflation protected securities	**71.4**	**3.4**	12.9	0.6
Large-cap equities	**182.2**	**8.6**	242.7	11.7
Small-cap equities	**9.5**	**0.4**	11.5	0.6
International instruments	**32.3**	**1.5**	15.9	0.8
Other invested assets	**5.0**	**0.2**	5.7	0.3
Cash and cash equivalents	**89.1**	**4.2**	70.9	3.4
Total portfolio	**$ 2,130.2**	**100.0**	2,069.6	100.0

Investment Operations Revenue

Net investment income for the three and nine months ended September 30, 2008 increased $1.9 million and $4.7 million, respectively, from the same 2007 periods. The growth in net investment income is attributed to an increase in average invested assets, from $1,973.9 million at September 30, 2007 to $2,136.3 million at September 30, 2008 primarily due to the $92.0 million in cash received in conjunction with the Pooling change.

($ millions)	Three months ended September 30		Nine months ended September 30	
	2008	2007	**2008**	2007
Gross investment income:				
Fixed income securities	**$ 21.3**	18.7	**$ 60.8**	56.3
Equity securities	**1.3**	1.4	**4.1**	4.1
Other	**1.0**	1.4	**4.5**	3.9
Total gross investment income	**23.6**	21.5	**69.4**	64.3
Investment expenses	**0.6**	0.4	**1.7**	1.3
Net investment income	**$ 23.0**	21.1	**$ 67.7**	63.0
Average invested assets (at cost)	**$ 2,136.8**	1,983.8	**$ 2,136.3**	1,973.9
Annualized investment yield	**4.3**	4.3	**4.2**	4.3
Annualized investment yield after tax.	**3.7**	3.7	**3.7**	3.7
Net investment income, after tax	**$ 20.0**	18.3	**$ 58.9**	54.5
Effective tax rate	**13.3**	13.5	**13.1**	13.5

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Realized gains and losses on investment sales are summarized as follows:

($ millions)	Three months ended September 30, 2008		Nine months ended September 30, 2008	
	Realized Gains (Losses)	Proceeds Received on Sale	Realized Gains (Losses)	Proceeds Received On Sale
Realized gains:				
Fixed maturities	$ 0.8	$ 40.9	$ 1.5	$ 119.3
Equity securities	1.5	4.7	8.7	36.2
Total realized gains	2.3	45.6	10.2	155.5
Realized losses:				
Fixed maturities				
Equity securities	(6.6)	1.4	(13.9)	16.8
Total realized losses	(6.6)	1.4	(13.9)	16.8
Net realized losses on investments	$ (4.3)	$ 47.0	$ (3.7)	$ 172.3

During the three and nine months ended September 30, 2008, we sold certain fixed maturities to realize gains on the securities and to raise money to settle intercompany transactions, including intercompany dividends.

During the three and nine months ended September 30, 2008, equity sales were executed for various reasons, including the achievement of our price target. The $6.6 million and $13.9 million of realized losses for the three and nine months ended September 30, 2008 include the recognition of realized losses from sales activity of $0.7 million and $4.3 million, respectively. During the third quarter 2008, we recognized realized losses on the sale of two equity positions within the consumer sector due to recent changes in business conditions, which in our opinion, greatly diminished future business prospects. During the second quarter 2008, we recognized realized losses on the sale of four equity positions within the manufacturing, consumer and financial services sectors due to announced changes in business conditions, which in our opinion, diminished their future business prospects. During the first quarter 2008, we re-evaluated our investment and commercial bank holdings, in response to the adverse market reaction during the quarter to negative earnings of various large companies within this sector, and subsequently sold three equity positions within the financial services sector each at a loss.

We regularly monitor our investment portfolio for declines in value that are other-than-temporary, an assessment which 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 herein. Among the factors that management considers are the nature of the investment, severity and length of decline in fair value, events impacting the issuer, overall market conditions, and our intent and ability to hold securities until recovery. When a security in our investment portfolio 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. This results in a charge to earnings as a realized loss, which is not changed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in other comprehensive income.

We had no direct exposure to Lehman Brothers Holdings Inc. or its subsidiaries, American International Group Inc., and no exposure to the common or preferred shares of Federal Home Loan Mortgage Corporation (Freddie Mac), or Federal National Mortgage Associations (Fannie Mae). Our exposure to Freddie Mac and Fannie Mae is limited to senior debt issues and mortgage-backed pools, which amount to less than 4% of invested assets, with no impairments anticipated as a result. These securities are now backed by the government.

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The $6.6 million and $13.9 million of realized losses for the three and nine months ended September 30, 2008 include the recognition of other-than-temporary impairments in our equity portfolio of $5.9 million and $9.6 million, respectively.

During the three and nine months ended September 30, 2008, we recognized other-than-temporary impairments within the financial services, consumer cyclical, consumer non-cyclical, industrial and technology sectors from our large cap equity portfolio, which totaled $5.4 and $7.3 million, respectively. The other-than-temporary impairments recognized in 2008 were limited to these securities, based on specific facts and judgments related to these particular issuers.

During the three and nine months ended September 30, 2008, we recognized $0.5 million and $2.3 million, respectively, in other-than-temporary impairments within our externally managed small cap equity portfolio, for which we are unable to make the assertion regarding our intent to hold securities in this portfolio that are currently valued below cost until recovery in the near term.

We did not recognize any other-than-temporary impairments on our fixed maturity or other invested assets portfolios during the first nine months of 2008.

For the three and nine months ended September 30, 2007 we recognized no other-than-temporary impairments.

Gross Unrealized Investment Gains and Losses

A review of our investment portfolio at September 30, 2008, 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 provides detailed information on our available-for-sale investment portfolio for our gross unrealized gains and losses at September 30, 2008:

($ millions, except # of positions)	Cost or amortized cost	Gross unrealized holding gains	Number of gain positions	Gross unrealized holding losses	Number of loss positions	Fair Value
Investment Category:						
Fixed Maturities:						
U.S. Treasury securities	$ 138.5	$ 1.9	26	$ 3.8	21	$ 136.6
States & political subdivisions	1,483.1	13.9	239	64.1	423	1,432.9
Corporate securities	11.8		1	0.6	13	11.2
Mortgage-backed securities of U.S. Gov. Agencies	178.7	1.0	10	4.4	60	175.3
Total fixed maturities	1,812.1	16.8	276	72.9	517	1,756.0
Equity Securities:						
Consumer	57.1	9.6	89	0.8	4	65.9
Technologies	33.4	2.4	65	4.0	6	31.8

Pharmaceuticals	1.7	0.4	4			2.1
Financial services	19.6	3.7	70	0.6	2	22.7
Manufacturing & other	67.3	7.0	168	5.1	19	69.2
Total equity securities	179.1	23.1	396	10.5	31	191.7
Other invested assets	44.0			7.8	4	36.2
Total investments	$ 2,035.2	$ 39.9	672	$ 91.2	552	$ 1,983.9

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The following table presents a summary of our cumulative unrealized holding gain (loss) by investment type, net of deferred taxes that are included as a component of accumulated comprehensive loss at September 30, 2008, and December 31, 2007, respectively, and the change in unrealized holding gain (loss), net of deferred tax, for nine months ended September 30, 2008.

($ millions)	**September 30, 2008**	December 31, 2007	$ Change
Available-for-sale investments			
Cumulative unrealized holing gain (loss):			
Fixed maturities	**$ (56.1)**	$ 22.5	$ (78.6)
Equities	**12.6**	44.0	(31.4)
Other invested assets	**(7.8)**	0.3	(8.1)
Cumulative unrealized holding (loss) gain	**(51.3)**	66.8	(118.1)
Deferred federal income tax asset (liability)	**17.9**	(23.4)	41.3
Cumulative unrealized holding (loss) gain, net of tax	**$ (33.4)**	$ 43.4	$ (76.8)

Fair Value Measurements

On January 1, 2008, we adopted SFAS No. 157, Fair Value Measurements (SFAS 157), which was issued by the FASB in September 2006. For financial statement elements currently required to be measured at fair value, SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP and enhances disclosures about fair value measurements. The new definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (exit price) regardless of whether an observable liquid market price exists. An exit price valuation will include margins for risk even if they are not observable.

SFAS 157 establishes a fair value hierarchy that categorizes the inputs to valuation techniques which are used to measure fair value into three broad levels as defined below:

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 table below shows our investments by level at September 30, 2008:

($ millions)	Total	Quoted Prices in Active Markets for	Significant Unobservable

		Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Inputs (Level 3)
Available-for-sale investments:				
Fixed maturities	$ 1,756.0	$	$ 1,753.8	$ 2.2
Equity securities	191.7	191.7		
Other invested assets	36.2	3.4		32.8
Total available-for-sale investments	$ 1,983.9	$ 195.1	$ 1,753.8	$ 35.0

As of September 30, 2008, Level 3 assets as a percentage of total assets were 1.4%, which we have determined to be insignificant.

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Other Income Statement Items

Interest expense on our debt was $1.8 million and $5.5 million versus $1.9 million and $5.6 million for the three and nine months ended September 30, 2008 and 2007, respectively.

Loss before federal income taxes for the three and nine months ended September 30, 2008 was $30.2 million and $69.4 million, respectively, compared to income of $28.6 million and $98.3 million, respectively, for the same 2007 periods. The pre-tax losses for the third quarter and the first nine months of 2008, were primarily the result of significant increases in catastrophe storm losses compared to the same 2007 periods. The uncertainty of our expected 2008 full year results precludes us from making a reliable estimate of the effective tax rate for the year. Accordingly, the Company recorded a tax benefit for the results of the nine months ended September 30, 2008. The effective tax rate for the three and nine months ended September 30, 2007 was 19.0% and 21.3%, respectively, which also reflects the impact of tax exempt investment income.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity refers to our ability to generate adequate amounts of cash to meet our needs to pay both long-term and short-term cash obligations as they come due. Our significant sources of cash are premiums, investment income, investment sales and the maturity of fixed security investments. The significant outflows of cash are payments of claims, commissions, premium taxes, operating expenses, income taxes, dividends, interest and principal payments on debt and investment purchases, along with payments made for the purchase of common shares under our stock repurchase program discussed below. The cash outflows can vary due to uncertainties regarding settlement of large losses or catastrophe events. As a result, we continually monitor our investment and reinsurance programs to ensure they are appropriately structured to enable our insurance subsidiaries to meet anticipated short and long-term cash requirements without the need to sell investments to meet fluctuations in their operating cash flow or the cash flow needs of State Auto Financial.

At September 30, 2008 and December 31, 2007, we had $89.1 million and $70.9 million, respectively, of cash and cash equivalents and $1,983.9 million and $2,019.9 million, respectively, of total investments at fair market value. Substantially all of our fixed maturity and equity securities are traded on public markets.

Net cash provided by operating activities was $157.5 million for the first nine months of 2008 versus $77.1 million for the same 2007 period. Materially impacting cash flows from operations in 2008 as compared to 2007 were the following:

- $92.0 million of cash received in 2008 in conjunction with the Pooling Change;
- Federal income tax payments of $18.0 million in 2008 compared to $39.3 million in 2007;
- Cash contribution to the defined benefit plan of $8.0 million in 2008 compared to $11.5 million during the comparable 2007 period.

Net cash used in investing activities was $91.7 million for the first nine months of 2008 compared to $20.8 million in the same 2007 period. The 2008 activities were driven primarily by the investment of $92.0 million received from the Pooling Change.

Net cash used in financing activities was $47.6 million for the first nine months of 2008 compared to $14.5 million during the same 2007 period. The current year includes $33.2 million used for common stock repurchases under our stock repurchase program discussed below. In addition we paid dividends of $17.9 million during the first nine of 2008 compared to $14.5 million for the same 2007 period.

On August 15, 2008, State Auto Financial s board of directors declared a quarterly cash dividend for $0.15 per share. The dividend was payable September 30, 2008 to shareholders of record at the close of business on September 15, 2008. This is the 69th consecutive quarterly cash dividend declared since STFC had its initial public offering in 1991. STFC s dividend payments have increased at a compound average annual growth rate of 17% since 1991.

To fund capital transactions and provide additional working capital to State Auto Financial, in March 2008 Milbank, Farmers, and State Auto National Insurance Company (SA National) declared cash dividends of $14.0 million and $4.0 million and $7.0 million, respectively. The cash transfer of dividends was completed in April 2008. The dividends from Milbank, Farmers and SA National were paid from unassigned statutory surplus and were not considered to be extraordinary for regulatory purposes.

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Borrowing Arrangements

The following provides an overview of our borrowing arrangements during 2008 and outstanding at September 30, 2008:

Senior Notes

In 2003, State Auto Financial issued $100.0 million of unsecured Senior Notes due November 2013. The Senior Notes bear interest at a fixed rate of 6.25% per annum, which is payable each May 15 and November 15. The Senior Notes are general unsecured obligations ranking senior to all existing and future subordinated indebtedness and equal with all existing and future senior indebtedness. The Senior Notes are not guaranteed by any of State Auto Financial s subsidiaries and thereby are effectively subordinated to all State Auto Financial s subsidiaries existing and future indebtedness. As of September 30, 2008, State Auto Financial was in compliance with all covenants related to the Senior Notes.

Trust Securities

State Auto Financial s Delaware business trust subsidiary (the Capital Trust) issued $15.0 million liquidation amount of capital securities in 2003, 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 the periods January 2007 through September 30, 2008 ranged from 6.88 to 9.78%.

Credit Agreement

State Auto Financial has a Credit Agreement (Credit Agreement) with a syndicate of lenders which provides for a $200.0 million five-year unsecured revolving credit facility (Credit Facility). During the term of the Credit Facility, we have the right to increase the total facility to a maximum amount of $250.0 million, provided that no event of default has occurred and is continuing. While the Credit Facility is available for general corporate purposes, including working capital, acquisitions and liquidity purposes, we intend to keep a portion of the Credit Facility available in the event there is a need to fund losses related to catastrophes. The Credit Facility provides for interest-only payments during its term, with principal due in full at maturity. Interest is based on either a London interbank market rate or a base rate plus a calculated margin amount. The Credit Agreement contains certain covenants, including financial covenants that require us to maintain a minimum net worth and not exceed a certain debt to capitalization ratio. As of September 30, 2008, State Auto Financial had not made any borrowings and was in compliance with all of the covenants under the Credit Agreement.

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. Except as described in the following paragraph, there have been no material changes in our reinsurance arrangements since December 31, 2007. For a discussion of our reinsurance arrangements, see Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Reinsurance Arrangements in Item 7 of the 2007 Form 10-K.

As of July 1, 2008, we made revisions to our property catastrophe reinsurance program by extending the coverage by $20.0 million. On a combined basis, the members of the State Auto Group now retain the first $55.0 million of catastrophe losses, each occurrence, with a 5% co-participation on the next $100 million (previously $80 million) of covered loss, each occurrence. We also renewed our property per risk, casualty excess of loss, workers compensation excess of loss and workers compensation catastrophe

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excess of loss programs as of July 1, 2008 with no material revisions. Overall, the change in cost for these programs is not expected to be material to our quarter or year to date results of operations. As previously reported, we did not renew the intercompany catastrophe agreement between State Auto P&C and the other members of the State Auto Group. See discussion in Results of Operations included in this Form 10-Q.

Stock Repurchase Program

On August 17, 2007, State Auto Financial s board of directors authorized the repurchase, from time to time, of up to 4.0 million of State Auto Financial s common shares, or approximately 10% of State Auto Financial s outstanding shares, over a period extending to and through December 31, 2009. State Auto Financial will repurchase shares from State Auto Mutual in amounts that are proportional to the respective current ownership percentages of State Auto Mutual, which is approximately 64%, and other shareholders. There were no common shares purchased under this program for the three months ended September 30, 2008. For the nine months ended September 30, 2008 a total 1,214,586 common shares were purchased under this program at an average purchase price of $27.25 for a total of $33.1 million. Since inception through September 30, 2008, a total 2,028,116 common shares have been purchased under this program at an average purchase price of $27.26 for a total of $55.3 million.

Regulatory Considerations

At September 30, 2008, all of our insurance subsidiaries were in compliance with statutory requirements relating to capital adequacy.

Other

Employee Benefit Plans

In October 2008, we announced a substantive change to increase retiree cost sharing within the postretirement medical plan, effective January 1, 2009. This change will allow us to manage our overall company costs and continue to provide a competitive retiree medical plan for all associates and current retirees. The increase will be phased in over five years for current retirees and those associates who announce their retirement before the end of the year and retire in the first half of 2009.

The following table provides the incremental effect on our balance sheet at October 1, 2008, for remeasurement of the postretirement benefit obligation for this cost sharing change:

($ millions)	September 30 2008	Effect of Remeasurement	October 1 2008
Assets:			
Deferred federal income taxes	$ 94.2	(18.0)	76.2
Liabilities:			
Postretirement benefits	$ 128.8	(45.0)	83.8
Stockholder s Equity:			
Accumulated other comprehensive loss	$ (75.3)	27.0	(48.3)

In October 2008, we offered an early retirement incentive option to retirement eligible associates. This early retirement option is deemed a special termination benefit under SFAS No 88 Employers Accounting for Settlements and Curtailments of Define Benefit Pension Plans and for Termination Benefits. An employer offering special termination benefits to employees must recognize a liability and an expense when the following conditions are met: 1) the employees accept the offer, and 2) the amount can be reasonably estimated. We will recognize an expense during the fourth quarter 2008 for the acceleration of certain benefits for those retirement eligible associates who elect early retirement. We estimate this expense to be up to $4.0 million depending on the number who elect to participate.

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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 2007 Compared to 2006 Investment Operations Segment Market Risk in Item 7 of the 2007 Form 10-K. There have been no material changes from the information reported regarding Market Risk in the 2007 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.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

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

1. Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission;

2. Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure; and

3. Our disclosure controls and procedures are effective in timely making known to them material information required to be included in our periodic filings with the Securities and Exchange Commission.

Changes in Internal Control over Financial Reporting

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

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in the 2007 Form 10-K under Part I, Item 1A Risk Factors.

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

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (in whole numbers)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[1]	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased under the Plans or Programs
07/01/08 thru 07/31/08		$		1,971,884
08/01/08 thru 08/31/08	11,017	30.34		1,971,884
09/01/08 thru 09/30/08	4,249	37.01		1,971,884
Total	15,266[2]	$ 32.20		

(1) On August 17, 2007, State Auto Financial announced that its board of directors had authorized the repurchase, from time to time, of up to 4.0 million of its common shares, or approximately 10% of State Auto Financial s outstanding shares, over a period extending until December 31, 2009. State Auto Financial will repurchase shares from State Auto Mutual in amounts that are proportional to the respective current ownership percentages of State Auto Mutual, which is approximately 64%, and other shareholders.

(2) These shares acquired as a result of stock swap option exercises.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None.

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Item 6. Exhibits

Exhibit No.	Description of Exhibits
10.01	Amendment No. 2 effective as of January 1, 2009 to the Supplemental Retirement Plan for Executive Employees of State Auto Insurance Companies (Restatement) effective as of January 1, 1994
10.02	Second Amendment effective as of January 1, 2009 to State Auto Insurance Companies Amended and Restated Directors Deferred Compensation Plan
10.03	Second Amendment effective as of January 1, 2009 to the State Auto Property & Casualty Insurance Company Amended and Restated Incentive Deferred Compensation Plan
10.04	First Amendment effective as of January 1, 2009 to the State Auto Financial Corporation Leadership Bonus Plan
10.05	Second Amendment effective as of January 1, 2009 to the State Auto Financial Corporation Long-Term Incentive Plan
31.01	CEO certification required by Section 302 of Sarbanes Oxley Act of 2002
31.02	CFO certification required by Section 302 of Sarbanes Oxley Act of 2002
32.01	CEO certification required by Section 906 of Sarbanes Oxley Act of 2002
32.02	CFO certification required by Section 906 of Sarbanes Oxley Act of 2002

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SIGNATURE

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

State Auto Financial Corporation

Date: November 5, 2008

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