

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

State Auto Financial CORP

Form 10-Q

May 03, 2017

false--12-31Q1201710-Q0000874977Accelerated FilerState Auto Financial

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

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2017

or

Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

Ohio
(State or other jurisdiction of
incorporation or organization)

31-1324304
(I.R.S. Employer
Identification No.)

518 East Broad Street, Columbus, Ohio 43215-3976

(Address of principal executive offices) (Zip Code)

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

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

Yes No

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

Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company) Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

On April 28, 2017, the Registrant had 42,002,494 Common Shares outstanding.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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

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

	March 31,	December
	2017	31, 2016
	(unaudited)	
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$2,104.7 and \$2,095.9, respectively)	\$ 2,123.5	\$2,109.3
Equity securities, available-for-sale, at fair value (cost \$321.3 and \$323.1, respectively)	395.6	382.8
Other invested assets, available-for-sale, at fair value (cost \$25.5 and \$25.5, respectively)	48.1	45.1
Other invested assets	5.4	5.4
Notes receivable from affiliate	70.0	70.0
<i>Total investments</i>	2,642.6	2,612.6
Cash and cash equivalents	44.8	51.1
Accrued investment income and other assets	46.6	40.0
Deferred policy acquisition costs (affiliated net assumed \$47.6 and \$50.7, respectively)	124.0	129.8
Reinsurance recoverable on losses and loss expenses payable	4.8	3.6
Prepaid reinsurance premiums	6.0	6.1
Due from affiliate	1.1	—
Current federal income taxes	6.8	6.7
Net deferred federal income taxes	94.9	102.1
Property and equipment, at cost	7.3	7.4
Total assets	\$ 2,978.9	\$2,959.4
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliated net assumed \$646.8 and \$630.9, respectively)	\$ 1,217.3	\$1,181.6
Unearned premiums (affiliated net assumed \$222.2 and \$220.9, respectively)	606.5	617.8
Notes payable (affiliates \$15.2 and \$15.2, respectively)	122.1	122.1
Postretirement and pension benefits (affiliated net ceded \$38.3 and \$40.1, respectively)	71.2	74.4
Due to affiliate	—	2.4
Other liabilities (affiliated net assumed \$16.5 and \$11.0, respectively)	60.7	69.8
Total liabilities	2,077.8	2,068.1
Stockholders' equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued	—	—
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued	—	—
Common stock, without par value. Authorized 100.0 shares; 48.8 and 48.6 shares issued, respectively, at stated value of \$2.50 per share	121.9	121.6
Treasury stock, 6.9 and 6.8 shares, respectively, at cost	(116.7)	(116.5)
Additional paid-in capital	162.6	159.9
Accumulated other comprehensive income (affiliated net ceded \$52.8 and \$53.7, respectively)	47.9	32.5
Retained earnings	685.4	693.8
Total stockholders' equity	901.1	891.3
Total liabilities and stockholders' equity	\$ 2,978.9	\$2,959.4

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

(\$ in millions, except per share amounts)

	Three months ended March 31	
(unaudited)	2017	2016
Earned premiums (affiliated net assumed \$114.8 and \$113.4, respectively)	\$317.3	\$319.9
Net investment income (affiliates \$1.2 and \$1.2, respectively)	18.7	17.4
Net realized gains on investments:		
Total other-than-temporary impairment losses	(2.1)	(3.7)
Other net realized investment gains	9.9	5.0
Total net realized gains on investments	7.8	1.3
Other income from affiliates	0.5	0.6
Total revenues	344.3	339.2
Losses and loss expenses (affiliated net assumed \$86.2 and \$93.7, respectively)	234.0	225.0
Acquisition and operating expenses (affiliated net assumed \$80.3 and \$70.6, respectively)	112.2	107.5
Interest expense (affiliates \$0.2 and \$0.2, respectively)	1.4	1.3
Other expenses	1.9	1.6
Total expenses	349.5	335.4
(Loss) income before federal income taxes	(5.2)	3.8
Federal income tax (benefit) expense:		
Current	(0.1)	—
Deferred	(1.0)	0.8
Total federal income tax (benefit) expense	(1.1)	0.8
Net (loss) income	\$(4.1)	\$3.0
(Loss) earnings per common share:		
Basic	\$(0.10)	\$0.07
Diluted	\$(0.10)	\$0.07
Dividends paid per common share	\$0.10	\$0.10

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income

	Three months ended March 31	
	2017	2016
<i>(\$ in millions, except per share amounts)</i>		
(unaudited)		
Net (loss) income	\$(4.1)	\$3.0
Other comprehensive income, net of tax:		
Net unrealized holding gains on investments:		
Unrealized holding gains	30.8	37.0
Reclassification adjustments for gains realized in net income	(7.8)	(1.3)
Income tax expense	(8.0)	(12.5)
<i>Total net unrealized holding gains on investments</i>	15.0	23.2
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Negative prior service cost	(1.4)	(1.4)
Net actuarial loss	2.1	2.4
Income tax expense	(0.3)	(0.4)
<i>Total net unrecognized benefit plan obligations</i>	0.4	0.6
<i>Other comprehensive income</i>	15.4	23.8
Comprehensive income	\$11.3	\$26.8

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Cash Flows

	Three months ended March 31	
	2017	2016
<i>(\$ in millions)</i>		
(unaudited)		
Cash flows from operating activities:		
Net (loss) income	\$(4.1)	\$3.0
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization, net	3.1	4.4
Share-based compensation	1.7	1.4
Net realized gains on investments	(7.8)	(1.3)
Changes in operating assets and liabilities:		
Deferred policy acquisition benefits	5.8	1.6
Accrued investment income and other assets	(0.5)	(3.7)
Postretirement and pension benefits	(2.9)	(1.8)
Other liabilities and due to/from affiliates, net	(14.0)	4.9
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	(1.1)	(0.1)
Losses and loss expenses payable	35.7	30.5
Unearned premiums	(11.3)	(15.5)
Federal income taxes	(0.9)	1.1
Net cash provided by operating activities	3.7	24.5
Cash flows from investing activities:		
Purchases of fixed maturities available-for-sale	(120.5)	(160.6)
Purchases of equity securities available-for-sale	(39.0)	(30.8)
Purchases of other invested assets	(0.2)	(0.4)
Maturities, calls and pay downs of fixed maturities available-for-sale	54.1	60.8
Sales of fixed maturities available-for-sale	50.7	75.8
Sales of equity securities available-for-sale	47.6	23.6
Sales of other invested assets available-for-sale	0.3	0.2
Net cash used in investing activities	(7.0)	(31.4)
Cash flows from financing activities:		
Proceeds from issuance of common stock	1.5	0.8
Payments to acquire treasury stock	(0.2)	(0.2)
Payment of dividends	(4.3)	(4.1)
Net cash used in financing activities	(3.0)	(3.5)
Net decrease in cash and cash equivalents	(6.3)	(10.4)
Cash and cash equivalents at beginning of period	51.1	58.1
Cash and cash equivalents at end of period	\$44.8	\$47.7
<u>Supplemental disclosures:</u>		
Interest paid (affiliates \$0.2 and \$0.2, respectively)	\$1.4	\$1.3

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries (“State Auto Financial” or the “Company”) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2017, are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. The balance sheet at December 31, 2016, has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2016, (the “2016 Form 10-K”). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2016 Form 10-K.

Adoption of Recent Accounting Pronouncements

Improvements to Employee Share-Based Payment Accounting

The amendments in this guidance simplify the accounting for share-based payment award transactions including: income tax consequences, classification of awards as either equity or liabilities, classification of excess tax benefits, and classification on the statement of cash flows. The guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The Company adopted this guidance prospectively at January 1, 2017. Prior periods were not adjusted and it did not have a material impact on the condensed consolidated financial statements for the three month period ended March 31, 2017.

Pending Adoption of Recent Accounting Pronouncements

For information regarding accounting pronouncements that the Company has not yet adopted, see the “Pending Adoption of Recent Accounting Pronouncements” section of Note 1 of the Notes to Consolidated Financial Statements in the 2016 Form 10-K.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

2. Investments

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at March 31, 2017 and December 31, 2016:

(\$ millions)

March 31, 2017

Fixed maturities:

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
U.S. treasury securities and obligations of U.S. government agencies	\$441.3	\$9.9	\$(5.7)	\$445.5
Obligations of states and political subdivisions	607.3	14.1	(2.3)	619.1
Corporate securities	431.6	6.3	(1.7)	436.2
U.S. government agencies mortgage-backed securities	624.5	7.9	(9.7)	622.7
<i>Total fixed maturities</i>	2,104.7	38.2	(19.4)	2,123.5
Equity securities:				
Large-cap securities	97.4	39.3	(0.2)	136.5
Small-cap securities	56.0	20.5	—	76.5
Mutual and exchange traded funds	167.9	14.8	(0.1)	182.6
<i>Total equity securities</i>	321.3	74.6	(0.3)	395.6
Other invested assets	25.5	22.6	—	48.1
<i>Total available-for-sale securities</i>	\$2,451.5	\$135.4	\$(19.7)	\$2,567.2

(\$ millions)

December 31, 2016

Fixed maturities:

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
U.S. treasury securities and obligations of U.S. government agencies	\$401.9	\$8.9	\$(6.1)	\$404.7
Obligations of states and political subdivisions	634.6	12.3	(3.2)	643.7
Corporate securities	445.7	6.1	(2.2)	449.6
U.S. government agencies mortgage-backed securities	613.7	8.5	(10.9)	611.3
<i>Total fixed maturities</i>	2,095.9	35.8	(22.4)	2,109.3
Equity securities:				
Large-cap securities	108.9	32.7	(2.6)	139.0
Small-cap securities	57.2	21.9	—	79.1
Mutual and exchange traded funds	157.0	8.5	(0.8)	164.7
<i>Total equity securities</i>	323.1	63.1	(3.4)	382.8
Other invested assets	25.5	19.6	—	45.1
<i>Total available-for-sale securities</i>	\$2,444.5	\$118.5	\$(25.8)	\$2,537.2

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's gross unrealized losses and fair value on its investments by lot, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at March 31, 2017 and December 31, 2016:

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
March 31, 2017									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$257.0	\$(5.7)	35	\$—	\$—	—	\$257.0	\$(5.7)	35
Obligations of states and political subdivisions	126.6	(2.3)	17	—	—	—	126.6	(2.3)	17
Corporate securities	114.0	(1.3)	17	15.7	(0.4)	3	129.7	(1.7)	20
U.S. government agencies mortgage-backed securities	347.5	(8.9)	49	20.0	(0.8)	9	367.5	(9.7)	58
<i>Total fixed maturities</i>	845.1	(18.2)	118	35.7	(1.2)	12	880.8	(19.4)	130
Equity securities:									
Large-cap equity securities	1.3	—	2	4.6	(0.2)	2	5.9	(0.2)	4
Mutual and exchange traded funds	2.4	(0.1)	1	—	—	—	2.4	(0.1)	1
<i>Total equity securities</i>	3.7	(0.1)	3	4.6	(0.2)	2	8.3	(0.3)	5
<i>Total temporarily impaired securities</i>	\$848.8	\$(18.3)	121	\$40.3	\$(1.4)	14	\$889.1	\$(19.7)	135

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
December 31, 2016									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$229.1	\$(6.1)	30	\$—	\$—	—	\$229.1	\$(6.1)	30
Obligations of states and political subdivisions	178.9	(3.2)	26	—	—	—	178.9	(3.2)	26
Corporate securities	102.9	(1.4)	16	29.4	(0.8)	4	132.3	(2.2)	20
U.S. government agencies mortgage-backed securities	341.7	(10.1)	43	20.5	(0.8)	11	362.2	(10.9)	54
<i>Total fixed maturities</i>	852.6	(20.8)	115	49.9	(1.6)	15	902.5	(22.4)	130
Equity securities:									
Large-cap equity securities	9.1	(0.9)	7	8.8	(1.7)	5	17.9	(2.6)	12
Mutual and exchange traded funds	29.9	(0.8)	2	—	—	—	29.9	(0.8)	2
<i>Total equity securities</i>	39.0	(1.7)	9	8.8	(1.7)	5	47.8	(3.4)	14
<i>Total temporarily impaired securities</i>	\$891.6	\$(22.5)	124	\$58.7	\$(3.3)	20	\$950.3	\$(25.8)	144

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The Company reviewed its investments at March 31, 2017, and determined that no additional other-than-temporary impairment existed in the gross unrealized holding losses other than those listed in the table below. The following table sets forth the realized losses related to other-than-temporary impairments on the Company's investment portfolio recognized for the three months ended March 31, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Equity securities:		
Large-cap securities	\$(1.5)	\$(0.2)
Small-cap securities	(0.6)	(1.2)
Fixed maturities:	—	(2.3)
<i>Total other-than-temporary impairments</i>	\$(2.1)	\$(3.7)

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

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

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at March 31, 2017:

<i>(\$ millions)</i>	Amortized cost	Fair value
Due in 1 year or less	\$ 52.1	\$52.6
Due after 1 year through 5 years	540.6	546.7
Due after 5 years through 10 years	306.6	310.0
Due after 10 years	580.9	591.5
U.S. government agencies mortgage-backed securities	624.5	622.7
<i>Total</i>	\$ 2,104.7	\$ 2,123.5

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

At March 31, 2017, State Auto P&C had U.S. government agencies mortgage-backed fixed maturity securities, with a carrying value of approximately \$106.5 million, that were pledged as collateral for the FHLB Loans (as defined in Note 3). In accordance with the terms of the FHLB Loans, State Auto P&C retains all rights regarding these pledged securities.

Fixed maturities with fair values of \$9.3 million and \$9.2 million were on deposit with insurance regulators as required by law at March 31, 2017, and December 31, 2016, respectively. The Company retains all rights regarding these securities.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the components of net investment income for the three months ended March 31, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Fixed maturities	\$15.8	\$14.9
Equity securities	1.7	1.5
Cash and cash equivalents, and other	1.5	1.4
<i>Investment income</i>	19.0	17.8
Investment expenses	0.3	0.4
<i>Net investment income</i>	\$18.7	\$17.4

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

Proceeds on sales of available-for-sale securities were \$98.6 million and \$99.6 million for the three months ended March 31, 2017, and 2016, respectively.

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three months ended March 31, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Realized gains:		
Fixed maturities	\$0.3	\$1.5
Equity securities	9.7	4.1
<i>Total realized gains</i>	10.0	5.6
Realized losses:		
Equity securities:		
Sales	(0.1)	(0.6)
OTTI	(2.1)	(1.4)
Fixed maturities:		
OTTI	—	(2.3)
<i>Total realized losses</i>	(2.2)	(4.3)
<i>Net realized gains on investments</i>	\$7.8	\$1.3
Change in unrealized holding gains (losses), net of tax:		
Fixed maturities	\$5.4	\$36.2
Equity securities	14.6	(1.0)
Other invested assets	3.0	0.5
Deferred federal income tax liability	(8.0)	(12.5)
<i>Change in net unrealized holding gains (losses), net of tax</i>	\$15.0	\$23.2

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

3. Fair Value of Financial Instruments

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

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

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

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

The Company utilizes one nationally recognized pricing service to estimate the majority of its available-for-sale investment portfolio's fair value. The Company obtains one price per security and the processes and control procedures employed by the Company are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company gains an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, the Company compares to other fair value pricing information gathered from other independent pricing sources. At March 31, 2017, and December 31, 2016, the Company did not adjust any of the prices received from the pricing service.

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

Transfers in and out of level categorizations are reported as having occurred at the beginning of the quarter in which the transfer occurred. There were no transfers between level categorizations during the three months ended March 31, 2017, and 2016.

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

Fixed Maturities

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

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Equities

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

Other Invested Assets

Included in other invested assets is one international fund (“the fund”) that invests in equity securities of foreign issuers and is managed by a third party investment manager. The fund had a fair value of \$38.4 million and \$35.7 million at March 31, 2017, and December 31, 2016, respectively, which was determined using the fund’s net asset value. The Company employs procedures to assess the reasonableness of the fair value of the fund including obtaining and reviewing the fund’s audited financial statements. There are no unfunded commitments related to the fund. The Company may not sell its investment in the fund; however, the Company may redeem all or a portion of its investment in the fund at net asset value per share with the appropriate prior written notice. In accordance with Accounting Standard Codification 820-10, this investment is measured at fair value using the net asset value per share practical expedient and has not been classified in the fair value hierarchy. Fair values presented here are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the condensed consolidated balance sheets. The remainder of the Company’s other invested assets consist primarily of holdings in publicly-traded mutual funds. The Company believes that its prices for these publicly-traded mutual funds based on an observable market price for an identical asset in an active market reflect their fair values and consequently these securities have been disclosed in Level 1.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's available-for-sale investments within the fair value hierarchy at March 31, 2017 and December 31, 2016:

<i>(\$ millions)</i>	Total	Level 1	Level 2	Level 3
March 31, 2017				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$445.5	\$—	\$445.5	\$—
Obligations of states and political subdivisions	619.1	—	619.1	—
Corporate securities	436.2	—	432.6	3.6
U.S. government agencies mortgage-backed securities	622.7	—	622.7	—
<i>Total fixed maturities</i>	2,123.5	—	2,119.9	3.6
Equity securities:				
Large-cap securities	136.5	136.5	—	—
Small-cap securities	76.5	76.5	—	—
Mutual and exchange traded funds	182.6	182.6	—	—
<i>Total equity securities</i>	395.6	395.6	—	—
Other invested assets	9.7	9.7	—	—
<i>Total available-for-sale investments</i>	\$2,528.8	\$405.3	\$2,119.9	\$3.6

<i>(\$ millions)</i>	Total	Level 1	Level 2	Level 3
December 31, 2016				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$404.7	\$—	\$404.7	\$—
Obligations of states and political subdivisions	643.7	—	643.7	—
Corporate securities	449.6	—	446.1	3.5
U.S. government agencies mortgage-backed securities	611.3	—	611.3	—
<i>Total fixed maturities</i>	2,109.3	—	2,105.8	3.5
Equity securities:				
Large-cap securities	139.0	139.0	—	—
Small-cap securities	79.1	79.1	—	—
Mutual and exchange traded funds	164.7	164.7	—	—
<i>Total equity securities</i>	382.8	382.8	—	—
Other invested assets	9.4	9.4	—	—
<i>Total available-for-sale investments</i>	\$2,501.5	\$392.2	\$2,105.8	\$3.5

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), the following tables set forth a reconciliation of the beginning and ending balances for the three months ended March 31, 2017, and the year ended December 31, 2016, separately for each major category of assets:

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2017	\$ 3.5
Total realized gains – included in earnings	—
Total unrealized losses – included in other comprehensive income	—
Purchases	0.1
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at March 31, 2017	\$ 3.6

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2016	\$ 3.3
Total realized gains – included in earnings	—
Total unrealized gains – included in other comprehensive income	—
Purchases	0.2
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at December 31, 2016	\$ 3.5

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

Financial Instruments Disclosed, But Not Carried, At Fair Value

Other Invested Assets

Included in other invested assets are common stock of the Federal Home Loan Bank of Cincinnati (the "FHLB") and the Trust Securities. The Trust Securities and FHLB common stock are carried at cost, which approximates fair value. The fair value of the FHLB common stock at March 31, 2017, was \$4.9 million and the fair value of the Trust Securities was \$0.5 million. The investments have been placed in Level 3 of the fair value hierarchy.

Notes Receivable from Affiliate

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

<i>(\$ millions, except interest rates)</i>	March 31, 2017			December 31, 2016		
	Carrying	fair	Interest	Carrying	fair	Interest
	value	value	rate	value	value	rate
Notes receivable from affiliate	\$70.0	\$74.3	7.00 %	\$70.0	\$75.7	7.00 %

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Notes Payable

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

(\$ millions, except interest rates)

	March 31, 2017			December 31, 2016		
	Carrying value	Fair Value	Interest rate	Carrying value	Fair value	Interest rate
FHLB Loan due 2021: issued \$21.5, September 2016 with fixed interest	\$21.5	\$21.0	1.73 %	\$21.5	\$21.0	1.73 %
FHLB Loan due 2033: issued \$85.0, July 2013 with fixed interest	85.4	85.3	5.03 %	85.4	85.6	5.03 %
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.2	15.2	5.25 %	15.2	15.2	5.13 %
<i>Total notes payable</i>	\$122.1	\$121.5		\$122.1	\$121.8	

4. Losses and Loss Expenses Payable

The following table sets forth the activity in the liability for losses and loss expenses for the three months ended March 31, 2017 and 2016:

(\$ millions)

	2017	2016
Losses and loss expenses payable, at beginning of period	\$1,181.6	\$1,053.0
Less: reinsurance recoverable on losses and loss expenses payable	3.6	5.9
<i>Net balance at beginning of period</i>	1,178.0	1,047.1
Incurred related to:		
Current year	243.7	215.4
Prior years	(9.7)) 9.6
<i>Total incurred</i>	234.0	225.0
Paid related to:		
Current year	60.1	52.3
Prior years	139.4	142.8
<i>Total paid</i>	199.5	195.1
<i>Net balance at end of period</i>	1,212.5	1,077.0
Plus: reinsurance recoverable on losses and loss expenses payable	4.8	6.5
<i>Losses and loss expenses payable, at end of period</i>	\$1,217.3	\$1,083.5

The Company recorded favorable development related to prior years' loss and loss expense reserves for the three months ended March 31, 2017, of \$9.7 million compared to adverse development of \$9.6 million for the same 2016 period. Favorable development of prior years' unallocated loss adjustment expenses and catastrophe reserves were approximately \$2.7 million and \$2.2 million, respectively, of the 2017 development. Favorable development of prior accident years' non-catastrophe loss and ALAE reserves was primarily driven by the commercial insurance segment. The commercial insurance segment non-catastrophe loss and ALAE reserves contributed \$7.6 million of favorable development in 2017, driven by other commercial, small commercial package and workers' compensation of \$3.2 million, \$2.0 million and \$1.9 million, respectively. Favorable development in these lines was driven by lower than

anticipated severity emerging from multiple accident years. Slightly offsetting the favorable development was adverse development in the personal insurance segment of \$2.3 million, driven by homeowners' which contributed \$2.8 million of adverse development, primarily from accident year 2016, which included three large losses that occurred in late 2016.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Favorable development of catastrophe reserves was approximately \$0.7 million for the three months ended March 31, 2016, and adverse development of unallocated loss adjustment expenses was \$1.6 million for the same 2016 period. The specialty insurance segment non-catastrophe loss and ALAE reserves accounted for \$4.9 million of adverse development, which was driven by programs with adverse development of \$3.9 million. Adverse development in programs was primarily due to two programs with commercial auto exposures, both of which are in run-off. The personal insurance segment contributed \$3.4 million of the adverse development, driven by personal auto which developed unfavorably by \$3.2 million, primarily due to higher than anticipated bodily injury severity from the prior two accident years.

5. Reinsurance

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

The following table sets forth a summary of the Company’s external reinsurance transactions, as well as reinsurance transactions with State Auto Mutual under the Pooling Arrangement, for the three months ended March 31, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Premiums earned:		
Assumed from external insurers and reinsurers	\$1.1	\$1.4
Assumed under Pooling Arrangement	317.3	319.9
Ceded to external insurers and reinsurers	(6.1)	(6.8)
Ceded under Pooling Arrangement	(202.5)	(206.5)
<i>Net assumed premiums earned</i>	\$109.8	\$108.0
Losses and loss expenses incurred:		
Assumed from external insurers and reinsurers	\$1.6	\$1.1
Assumed under Pooling Arrangement	234.4	225.4
Ceded to external insurers and reinsurers	(2.0)	(1.9)
Ceded under Pooling Arrangement	(148.2)	(131.7)
<i>Net assumed losses and loss expenses incurred</i>	\$85.8	\$92.9

6. Income Taxes

The following table sets forth the reconciliation between actual federal income tax (benefit) expense and the amount computed at the indicated statutory rate for the three months ended March 31, 2017 and 2016:

<i>(\$ millions)</i>	2017		2016	
Amount at statutory rate	\$(1.8)	35.0	%	\$1.3 35.0 %
Tax-exempt interest and dividends received deduction	(1.5)	29.1	(2.0)	(52.8)
Other, net	2.2	(42.4)	1.5	37.8
<i>Federal income tax (benefit) expense and effective rate</i>	\$(1.1)	21.7	%	\$0.8 20.0 %

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

7. Pension and Postretirement Benefit Plans

The following table sets forth the components of net periodic cost for the Company's pension and postretirement benefit plans for the three months ended March 31, 2017 and 2016:

(\$ millions)	Pension		Postretirement	
	2017	2016	2017	2016
Service cost	\$1.7	\$1.6	\$—	\$—
Interest cost	2.9	2.9	0.2	0.2
Expected return on plan assets	(4.2)	(3.7)	—	—
Amortization of:				
Negative prior service cost	—	—	(1.4)	(1.4)
Net actuarial loss	2.0	2.3	0.1	0.1
<i>Net periodic cost (benefit)</i>	\$2.4	\$3.1	\$(1.1)	\$(1.1)

The Company contributed \$3.3 million to its pension plan for the three months ended March 31, 2017, and expects to contribute an additional \$6.5 million in 2017.

8. Other Comprehensive Income and Accumulated Other Comprehensive Income

The following table sets forth the changes in the Company's accumulated other comprehensive income component ("AOCI"), net of tax, for the three months ended March 31, 2017 and 2016:

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Total
	Beginning balance at January 1, 2017	\$ 62.8	\$(30.3)
Other comprehensive income before reclassifications Amounts reclassified from AOCI (a)	—	—	20.1
Net current period other comprehensive	5.1	0.4	(4.7)
	15.0	0.4	15.4

income
*Ending
 balance*
 at \$ 77.8 \$(29.9) \$47.9
March
 31,
 2017

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

Other
 comprehensive
 loss 24.0 — 24.0
 before
 reclassifications
 Amounts
 reclassified
 from 0.8) 0.6 (0.2)
 AOCI
 (a)

Net
 current
 period 23.2 0.6 23.8
 other
 comprehensive
 income
*Ending
 balance*
 at \$ 91.7 \$(30.3) \$61.4
March
 31,
 2016

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

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the reclassifications out of accumulated other comprehensive income, by component, to the Company's condensed consolidated statement of income for the three months ended March 31, 2017 and 2016:

(\$

millions)

Three

Months Ended March 31, 2017 and 2016

ended

Comprehensive Income
Consolidated Statements of Income

Components

2017 2016

Unrealized

gains

on

available

for

sale

securities