State Auto Financial CORP
Form 10-K
March 12, 2007
**Table of Contents**

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

# FORM 10-K

x **Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the fiscal year ended December 31, 2006 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**<br>**(State or other jurisdiction of incorporation or organization)** | **31-1324304**<br>**(I.R.S. Employer Identification No.)** |
| **518 East Broad Street, Columbus, Ohio**<br>**(Address of principal executive offices)** | **43215-3976**<br>**(Zip Code)** |

**Registrant s telephone number, including area code:**

**(614) 464-5000**

**Securities registered pursuant to Section 12(b) of the Act: None**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Shares, without par value**

---

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 Act). Yes ¨ No x

As of June 30, 2006, the last business day of the Registrant s most recently completed second fiscal quarter, the aggregate market value (based on the closing sales price on that date) of the voting stock held by non-affiliates of the Registrant was $465,863,913.

On March 2, 2007, the Registrant had 41,079,773 Common Shares outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant s Proxy Statement relating to the annual meeting of stockholders to be held May 4, 2007 (the 2007 Proxy Statement ), which will be filed within 120 days of December 31, 2006, are incorporated by reference into Part III of this Form 10-K.

---

**Table of Contents**

Table of Contents

**IMPORTANT INFORMATION REGARDING FORWARD-LOOKING STATEMENTS**

All statements, other than statements of historical facts, included in this Annual Report on Form 10-K (this Form 10-K ) of State Auto Financial Corporation ( State Auto Financial or STFC ) or incorporated herein by reference, including, without limitation, statements regarding State Auto Financial s future financial position, business strategy, budgets, projected costs, goals and plans and objectives of management for future operations, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally can be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, believe or continue or the negative thereof or variations thereon or similar terminology. Forward-looking statements speak only as the date the statements were made. Although State Auto Financial believes that the expectations reflected in forward-looking statements have a reasonable basis, it 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 State Auto Financial s actual results to differ materially from those projected, see Risk Factors in Item 1A of this Form 10-K. Except to the limited extent required by applicable law, State Auto Financial undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**IMPORTANT DEFINED TERMS USED IN THIS FORM 10-K**

As used in this Form 10-K, the following terms have the meanings ascribed below:

State Auto Financial or STFC refers to State Auto Financial Corporation;

We, us, our or the Company refers to STFC and its consolidated subsidiaries, namely State Auto Property & Casualty Insuranc Company ( State Auto P&C ), Milbank Insurance Company ( Milbank ), Farmers Casualty Insurance Company ( Farmers ), State Auto Insurance Company of Ohio ( SA Ohio ), State Auto National Insurance Company ( SA National ), Stateco Financial Services, Inc. ( Stateco ), Strategic Insurance Software, Inc. ( S.I.S. ) and 518 Property Management and Leasing, LLC ( 518 PML );

State Auto Mutual or our parent company refers to State Automobile Mutual Insurance Company, which owns approximately 65% of STFC s outstanding common shares;

The Pooled Companies or our Pooled Companies refer to State Auto P&C, Milbank, Farmers, SA Ohio (referred to as the STFC Pooled Companies ), State Auto Mutual, and certain subsidiaries and affiliates of State Auto Mutual, namely State Auto Florida Insurance Company ( SA Florida ), State Auto Insurance Company of Wisconsin ( SA Wisconsin ), Meridian Security Insurance Company ( Meridian Security ) and Meridian Citizens Mutual Insurance Company ( Meridian Citizens Mutual ) (State Auto Mutual, SA Florida, SA Wisconsin, Meridian Security and Meridian Citizens Mutual are referred to as the Mutual Pooled Companies ); and

The State Auto Group or our Group refers to the Pooled Companies and SA National.

**PART I**

**Item 1. Business**

**(a) General Development of Business**

State Auto Financial is an Ohio domiciled super-regional property and casualty insurance holding company incorporated in 1990. We are primarily engaged in writing both personal and business lines of insurance. State Auto Financial owns 100% of State Auto P&C, Milbank, Farmers, SA Ohio, and SA National, each of which is a property and casualty insurance company. Our operations are headquartered in Columbus, Ohio.

1

Table of Contents

Our parent company, State Auto Mutual, is an Ohio domiciled super-regional mutual property and casualty insurance company organized in 1921. It owns approximately 65% of State Auto Financial s outstanding common shares. It also owns 100% of SA Florida and SA Wisconsin, each of which is a property and casualty insurance company. It also owns 100% of Meridian Insurance Group, Inc. ( MIGI ), an insurance holding company. MIGI owns 100% of Meridian Security, a property and casualty insurance company. MIGI is also a party to an affiliation agreement with Meridian Citizens Mutual, a mutual property and casualty insurance company. Meridian Security and Meridian Citizens Mutual are hereafter referred to collectively as the MIGI Insurers and together with MIGI, the MIGI Companies.

State Auto Financial owns 100% of Stateco, which provides investment management services to affiliated insurance companies. State Auto Financial also owns 100% of S.I.S., a developer and seller of insurance-related software. State Auto P&C and Stateco share ownership of 518 PML, which owns and leases property to affiliated companies. The results of the operations of S.I.S. and 518 PML are not material to our total operations.

State Auto P&C has participated in a quota share reinsurance pooling arrangement with our parent company since 1987 (the Pooling Arrangement ). Since January 1, 2005, the participants in the Pooling Arrangement have been State Auto P&C, State Auto Mutual, Milbank, SA Wisconsin, Farmers, SA Ohio, SA Florida, Meridian Security and Meridian Citizens Mutual. See Narrative Description of Business Pooling Arrangement in this Item 1 for further information regarding the Pooling Arrangement.

The State Auto Group writes a broad line of property and casualty insurance, such as standard personal and commercial automobile, nonstandard personal automobile, homeowners and farmowners, commercial multi-peril, workers compensation, general liability and property insurance, through approximately 2,900 independent insurance agencies in 28 states. Our Pooled Companies and SA National are rated A+ (Superior) by the A.M. Best Company.

**(b) Financial Information about Segments**

During 2006, we continued to operate our business in two significant reportable segments: standard insurance and nonstandard insurance. Financial information about our segments for 2006 is set forth in Note 15 to our Company s Consolidated Financial Statements included in Item 8 of our Form 10-K. Additional information regarding our Company s insurance and noninsurance segments is provided in Narrative Description of Business. Under the leadership of Robert P. Restrepo, Jr., our new Chairman, President and Chief Executive Officer, 2006 became a transitional year for the State Auto Group as we undertook initiatives to realign our internal organization, specifically our people, processes, internal reporting systems and compensation reward programs to become more focused within the business and personal insurance markets. While 2007 will continue to be a transitional year in certain areas of our Company, we have already implemented integrated personal and business insurance teams with product, profit and production responsibilities for their respective areas. As a result of these transitional efforts, beginning in 2007, our significant reportable segments will change from standard and nonstandard insurance to personal insurance and business insurance along with a third segment for investment operations, and we will begin reporting on those bases to our chief operating decision makers.

**(c) Narrative Description of Business**

**Property and Casualty Insurance**

**Pooling Arrangement**

Our Pooled Companies are parties to the Pooling Arrangement. Prior to 2005, the Pooling Arrangement was governed by the reinsurance pooling agreement known as the 2000 Pooling Agreement. Since January 1, 2005, the Pooling Arrangement has been governed by the reinsurance pooling agreement known as the 2005 Pooling Agreement. The Pooling Arrangement covers all the property and casualty insurance written by our Pooled Companies except voluntary assumed reinsurance written by our parent company, State Auto Middle Market

Table of Contents

Insurance (as defined in the 2005 Pooling Agreement) and intercompany catastrophe reinsurance written by State Auto P&C. Under the Pooling Arrangement, each of our Pooled Companies cedes premiums, losses and expenses on all of their business to State Auto Mutual, which in turn cedes to each of our Pooled Companies a specified portion of premiums, losses and expenses based on each of their respective pooling percentages. State Auto Mutual then retains the balance of the pooled business.

The following table sets forth a chronology of the participants and their participation percentage changes that have occurred in the Pooling Arrangement since January 1, 1996:

| Year[1] | State Auto Mutual | State Auto P&C | Milbank | SA Wisconsin | Farmers | SA Ohio | SA Florida | Meridian Security | Meridian Citizens Mutual |
|---|---|---|---|---|---|---|---|---|---|
| 1996 - 1997 | 55.0 | 35.0 | 10.0 | N/A | N/A | N/A | N/A | N/A | N/A |
| 1998 | 52.0 | 37.0 | 10.0(2) | 1.0 | N/A | N/A | N/A | N/A | N/A |
| 1999 | 49.0 | 37.0 | 10.0 | 1.0 | 3.0 | N/A | N/A | N/A | N/A |
| 2000-9/30/2001 | 46.0 | 39.0 | 10.0 | 1.0 | 3.0 | 1.0 | N/A | N/A | N/A |
| 10/1/2001-2002 | 19.0 | 59.0 | 17.0 | 1.0 | 3.0 | 1.0 | N/A | N/A | N/A |
| 2003 - 2004 | 18.3 | 59.0 | 17.0 | 1.0 | 3.0 | 1.0 | 0.7 | N/A | N/A |
| 1/1/2005 - current | 19.5 | 59.0 | 17.0 | 0.0 | 3.0 | 1.0 | 0.0 | 0.0 | 0.5 |

(1) Time period is for the year ended December 31, unless otherwise noted.
(2) In July 1998, Milbank became a 100% owned subsidiary of STFC. Previously, Milbank was a 100% owned subsidiary of State Auto Mutual.

The following table sets forth a summary of the Pooling Arrangement participation percentages of STFC and State Auto Mutual, aggregating their respective 100% owned subsidiaries:

| Year[1] | STFC Pooled Companies | Mutual Pooled Companies |
|---|---|---|
| 1996 - 1997 | 35 | 65 |
| 1/1/1998 - 6/30/1998 | 37 | 63 |
| 7/1/1998 - 12/31/1998 | 47 | 53 |
| 1999 | 50 | 50 |
| 2000 - 9/30/2001 | 53 | 47 |
| 10/1/2001 - 2006 | 80 | 20 |

(1) Time period is for the year ended December 31, unless otherwise noted.

In the aggregate, the pooling percentages for our Pooled Companies have remained at an 80% participation level since 2001. It is not management s current intention to recommend an adjustment to our Pooled Companies aggregate participation percentage in the foreseeable future. Under applicable governance procedures, if the 2005 Pooling Arrangement were to be amended, management would make recommendations to the independent committees of the Board of Directors of both State Auto Mutual and STFC. The independent committees review and evaluate such factors as they deem relevant and recommend any appropriate pooling change to the Board of Directors of both State Auto Mutual and us. The Pooling Arrangement is terminable by any of our Pooled Companies at any time after a 90-day notice or by mutual agreement of our Pooled Companies. None of our Pooled Companies currently intends to terminate the Pooling Arrangement.

Under the terms of the Pooling Arrangement, all subject premiums, incurred losses, loss expenses and other underwriting expenses are prorated among our Pooled Companies on the basis of their participation in the pool. By spreading the underwriting risk among each of our Pooled Companies, the Pooling Arrangement is designed

Table of Contents

to produce more uniform and stable underwriting results for each of our Pooled Companies than any one company would experience individually. One effect of the Pooling Arrangement is to provide each of our Pooled Companies with an identical mix of pooled property and casualty insurance business on a net basis.

The 2005 Pooling Agreement contains (and the 2000 Pooling Agreement contained) a provision excluding catastrophic losses and loss adjustment expenses incurred by our Pooled Companies in the amount of $100.0 million in excess of $135.0 million after June 30, 2006 ($120.0 million prior to July 1, 2006), as well as the premium for such exposures. State Auto P&C reinsures each insurer in the State Auto Group for this layer of reinsurance under a Catastrophe Assumption Agreement (defined below). No losses were paid by State Auto P&C under the Catastrophe Assumption Agreement in 2006, 2005 or 2004. See Narrative Description of Business Reinsurance in this Item 1 for further information regarding the Catastrophe Assumption Agreement.

**Nonstandard Auto Insurance**

We write nonstandard auto insurance through SA National. Nonstandard automobile programs provide insurance for private passenger automobile risks which do not qualify for the standard or preferred automobile insurance market. Typically, nonstandard risks have higher than average loss experience and an overall higher degree of risk than standard or preferred automobile business. We do not include the business of SA National in our Pooling Agreement. See Narrative Description of Business Marketing and Reportable Segments in this Item 1 for further information regarding our nonstandard auto insurance business.

**Management Agreement**

The employees of our subsidiary, State Auto P&C, provide all organizational, operational and management functions for all insurance affiliates within the State Auto Group through management and cost sharing agreements. State Auto Mutual provides facilities for all of our insurance affiliates under the same management and cost sharing agreements. A management and operations agreement, referred to as the 2005 Management Agreement, is in place among State Auto Mutual, State Auto P&C, State Auto Financial, Milbank, Farmers, SA Ohio, SA National, the MIGI Companies, Stateco, S.I.S. and 518 PML. The 2005 Management Agreement is a cost sharing agreement. A management agreement, referred to as the 2000 Midwest Management Agreement is in place among State Auto Mutual, State Auto P&C and SA Wisconsin. For the performance of SA Wisconsin s services under the 2000 Midwest Management Agreement, SA Wisconsin pays State Auto P&C a quarterly management and operations services fee of 0.75% of direct written premium. A separate cost sharing agreement is in place among State Auto Mutual, State Auto P&C and SA Florida.

Each of the affiliated management and cost sharing agreements has a ten-year term, except for the SA Florida cost sharing agreement, which has a five-year term. The SA Florida cost sharing agreement expires in 2007 and is renewed by mutual consent of the parties. The other cost sharing agreements automatically renew for an additional ten-year period unless terminated sooner in accordance with their terms. If the 2005 Management Agreement would be terminated for any reason, we would have to relocate our facilities to continue our operations. However, we do not currently anticipate the termination of the 2005 Management Agreement.

**Reportable Segments**

See Note 15, Reportable Segments, of the Notes to our Consolidated Financial Statements included in Item 8 of our Form 10-K and Item 7 of our Form 10-K.

**Marketing**

As of January 31, 2007, the State Auto Group marketed its standard products in 28 states (Colorado being our 28th state of operation beginning January 2007) through approximately 2,900 independent insurance agencies. None of the companies in the State Auto Group has any contracts with managing general agencies. As of January 31, 2007, SA National marketed its nonstandard auto products in 22 states exclusively through our network of independent agents. We anticipate continued state expansion for our products during 2007.

Table of Contents

Because independent insurance agents generally choose which products they recommend and provide their customers, we view our independent insurance agents as our primary customers. We strongly support the independent agency system and believe that maintenance of a strong agency system is essential to our present and future success. As such, we continually develop programs and procedures to enhance our agency relationships, including the following: regular travel by senior management and branch office staff to meet with agents, in person, in their home states; training opportunities; travel incentives related to profit and growth; sharing a portion of the underwriting profit generated by the agent s book of business; and an agent stock purchase plan.

We actively help our agencies develop professional sales skills within their staffs. Our training programs include both products and sales training conducted in our home office. Further, our training programs include disciplined follow-up and coaching for an extended time. Other targeted training sessions are held in our branch office locations from time to time.

We have made continuing efforts to use technology to make it easier for our agents to do business with us. We offer internet-based (i) rating, (ii) policy application submission and (iii) execution of changes to policies for certain products. In addition, we provide our agents with the opportunity to maintain policyholder records electronically, avoiding the expense of preparing and storing paper records. Software developed by S.I.S. also enhances the ability of our agents and us to take advantage of electronic data submission. We believe that, since agents and their customers realize better service and efficiency through automation, they value their relationship with us. Automation can make it easier for an agent to do business with us, which attracts prospective agents and enhances existing agencies relationships with us.

We share the cost of approved advertising with selected agencies. We provide our agents with defined travel and cash incentives if they achieve certain sales and underwriting profit levels. Further, we recognize our very top agencies measured by consistent profitability, achievement of written premium thresholds and growth as Inner Circle Agencies. Inner Circle Agencies are rewarded with additional trip and financial incentives, including additional profit sharing bonus and additional contributions to their Inner Circle Agent Stock Purchase Plan, a part of our Agent Stock Purchase Plan described below.

To strengthen agency commitment to producing profitable business and further develop our agency relationships, our Agent Stock Purchase Plan offers the opportunity to use commission income to purchase our stock. Our transfer agent administers the plan using commission dollars assigned by the agents to purchase shares on the open market through a stockbroker. We also make available to certain top performing agents the opportunity to vest grants of options in our common shares provided the participants meet performance targets described in our Agent Stock Option Plan.

We receive premiums on products marketed in Alabama, Arizona, Arkansas, Colorado, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maryland, Michigan, Minnesota, Mississippi, Missouri, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wisconsin. During 2006, the seven states that contributed the greatest percentage of our direct premiums written were as follows: Ohio (17.6%), Kentucky (11.2%), Indiana (7.6%), Tennessee (6.7%), Minnesota (5.5%), Pennsylvania (5.0%) and Maryland (5.0%).

**Claims**

Insurance claims on policies written by us are usually investigated and settled by staff claims adjusters. Our claims division emphasizes timely investigation of claims, settlement of meritorious claims for equitable amounts, maintenance of adequate case reserves for claims, and control of external claims adjustment expenses. Achievement of these goals supports our marketing efforts by providing agents and policyholders with prompt and effective service.

Table of Contents

Claim settlement authority levels are established for each adjuster, supervisor and manager based on his or her level of expertise and experience. Our claims division is responsible for reviewing the claim, obtaining necessary documentation and establishing loss and expense reserves of certain claims. Generally, property or casualty claims estimated to reach $150,000 or above are sent to our home office to be supervised by claims division specialists. Branches with low volumes of large claims are assigned a lower dollar threshold for referring claims to the home office. In territories in which there is not sufficient volume to justify having full-time adjusters, we use independent appraisers and adjusters to evaluate and settle claims under the supervision of claims division personnel.

We attempt to minimize claims adjusting costs by settling as many claims as possible through our internal claims staff and, if possible, by settling disputes regarding automobile physical damage and property insurance claims (first party claims) through arbitration. In addition, selected agents have authority to settle small first party claims, which improves claims service.

Our claim representatives use third party, proprietary bodily injury evaluation software to help them value bodily injury claims, except for the most severe injury cases. Our Claims Contact Centers allow us to improve claims efficiency and economy by concentrating the handling of smaller, less complex claims in a centralized environment. We provide 24 hour, seven days a week claim service, either through associates in our Claims Contact Centers, which are located in Des Moines, Iowa and Columbus, Ohio, or, for a few overnight hours, through a third party service provider.

**Reserves**

Loss reserves are management s best estimates at a given point in time of what we expect to pay in claims, based on facts, circumstances and historical trends then known. During the loss settlement period, additional facts regarding individual claims may become known, and consequently it often becomes necessary to refine and adjust the estimates of liability. The results of our 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.

We maintain reserves for the eventual payment of losses and loss expenses for both reported claims and incurred claims that have not yet been reported. Loss expense reserves are intended to cover the ultimate costs of settling all losses, including investigation, litigation and in-house claims processing costs from such losses.

Reserves for reported losses are initially established on either a case-by-case or formula basis depending on the type and circumstances of the loss. The case-by-case reserve amounts are determined based on our reserving practices, which take into account the type of risk, the circumstances surrounding each claim and policy provisions relating to types of loss. The formula reserves are based on historical paid loss data for similar claims with provisions for trend changes caused by inflation. Loss and loss expense reserves for incurred claims that have not yet been reported are estimated based on many variables including historical and statistical information, changes in exposure units, inflation, legal developments, storm loss estimates and economic conditions. Case and formula basis loss reserves are reviewed on a regular basis. As new data becomes available, estimates are updated resulting in adjustments to loss reserves. Generally, reported losses initially reserved on a formula basis which have not settled after six months, are case reserved at that time. Although our management uses many resources to calculate reserves, there is no precise method for determining the ultimate liability. We do not discount loss reserves for financial statement purposes. For additional information regarding our reserves, see Item 7 of this Form 10-K, Management, Discussion and Analysis of Financial Condition and Results of Operations Loss and Loss Expense Reserves.

State Auto P&C s December 31, 1990 liability for losses and loss expenses of $65.5 million has been guaranteed by State Auto Mutual. Pursuant to the guaranty agreement, all ultimate adverse development of the December 31, 1990 liability, if any, is to be reimbursed by State Auto Mutual to State Auto P&C in conformance with pooling percentages in place at that time. Through December 31, 2006, there has been no adverse development of the guaranteed liability. As of December 31, 2006, the remaining loss and loss expense liability is estimated to be $0.9 million.

**Table of Contents**

The following table presents our one-year development information on changes in the reserve for loss and loss expenses for each of the three years in the period ended December 31, 2006:

| *($ millions)* | Year Ended December 31 | | |
|---|---|---|---|
| | **2006** | 2005 | 2004 |
| Beginning of Year: | | | |
| Loss and loss expenses payable | **$ 728.7** | 681.8 | 643.0 |
| Less: Reinsurance recoverable on losses and loss expenses payable(1) | **17.4** | 25.9 | 14.2 |
| Net losses and loss expenses payable(2) | **711.3** | 655.9 | 628.8 |
| Provision for losses and loss expenses occurring: | | | |
| Current year | **659.3** | 657.7 | 641.4 |
| Prior years(3) | **(71.7)** | (44.3) | (22.2) |
| Total | **587.6** | 613.4 | 619.2 |
| Loss and loss expense payments for claims occurring during: | | | |
| Current year | **389.4** | 350.5 | 361.5 |
| Prior years | **248.5** | 242.8 | 230.6 |
| Total | **637.9** | 593.3 | 592.1 |
| Impact of pooling change, January 1, 2005 | | 35.3 | |
| End of Year: | | | |
| Net losses and loss expenses payable | **661.0** | 711.3 | 655.9 |
| Add: Reinsurance recoverable on losses and loss expenses payable(4) | **13.5** | 17.4 | 25.9 |
| *Losses and loss expenses payable(5)* | **$ 674.5** | 728.7 | 681.8 |

(1) Includes amounts due from affiliates of $5.5 million, $5.7 million, and $5.7 million at beginning of year 2006, 2005, and 2004, respectively.

(2) Includes net amounts assumed from affiliates of $302.6 million, $296.9 million, and $303.9 million at beginning of year 2006, 2005, and 2004, respectively.

(3) This line item shows decreases in the current calendar year in the provision for losses and loss expenses attributable to claims occurring in prior years. See discussion regarding the calendar year developments at Item 7 of our Form 10-K Management s Discussion and Analysis section at 2006 Compared to 2005 Expenses and 2005 Compared to 2004 Expenses.

(4) Includes amounts due from affiliates of $2.7 million, $5.5 million, and $5.7 million at end of year 2006, 2005, and 2004, respectively.

(5) Includes net amounts assumed from affiliates of $281.7 million, $302.6 million, and $296.9 million at end of year 2006, 2005, and 2004, respectively.

---

The following table sets forth our development of reserves for losses and loss expenses from 1996 through 2006. Net liability for losses and loss expenses payable sets forth the estimated liability for unpaid losses and loss expenses recorded at the balance sheet date, net of reinsurance recoverables, for each of the indicated years. This liability represents the estimated amount of losses and loss expenses for claims arising in the current and all prior years that are unpaid at the balance sheet date, including losses incurred but not reported to us.

The lower portion of the table shows the re-estimated amounts of the previously reported reserve based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the claims incurred.

The upper section of the table shows the cumulative amounts paid with respect to the previously reported reserve as of the end of each succeeding year. For example, through December 31, 2006, we have paid 90.0% of the currently estimated losses and loss expenses that had been incurred, but not paid, as of December 31, 1997.

Table of Contents

The amounts on the cumulative redundancy (deficiency) line represent the aggregate change in the estimates over all prior years. For example, the 1997 calendar year reserve has developed a $23.2 million or 11.9% deficiency through December 31, 2006. That amount has been included in operations over the ten years and did not have a significant effect on income in any one year. The effects on income caused by changes in estimates of the reserves for losses and loss expenses for the most recent three years are shown in the foregoing three-year loss development table.

In evaluating the information in the table, it should be noted that each amount includes the effects of all changes in amounts for prior periods. For example, the amount of the redundancy related to losses settled in 1999, but incurred in 1996, will be included in the cumulative redundancy or deficiency amounts for years 1997, 1998 and 1999. Conditions and trends that have affected the development of the liability in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on this table.

In 1998, 1999, 2000 and 2001 the Pooling Arrangement was amended to increase our share of premiums, losses and expenses and in 2005 to add the business of two companies within the State Auto Group, the MIGI Insurers. An amount of assets equal to the increase in net liabilities was transferred to us from our parent company in 1998, 1999, 2000 and 2001 in conjunction with each year s respective pooling change and in 2005 from our subsidiaries, the MIGI Insurers. The amount of the assets transferred in 1998, 1999, 2000, 2001 and 2005 has been netted against and has reduced the cumulative amounts paid for years prior to 1998, 1999, 2000, 2001 and 2005, respectively.

**Table of Contents**

| *($ millions)* | Years Ended December 31 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** |
| Net liability for losses and loss expenses payable | $ 199.5 | $ 194.2 | $ 205.0 | $ 221.7 | $ 236.7 | $ 509.9 | $ 592.1 | $ 628.8 | $ 655.9 | $ 711.3 | $ 661.0 |
| Paid (cumulative) as of: | | | | | | | | | | | |
| One year later | 39.4% | 32.7% | 35.4% | 41.8% | 5.9% | 43.4% | 41.2% | 36.7% | 31.6% | 34.9% | |
| Two years later | 54.1% | 54.6% | 61.6% | 43.0% | 52.7% | 65.3% | 60.8% | 53.2% | 48.4% | | |
| Three years later | 65.0% | 70.1% | 62.1% | 71.9% | 79.9% | 78.4% | 71.4% | 63.3% | | | |
| Four years later | 73.2% | 69.2% | 78.8% | 86.9% | 95.5% | 84.4% | 77.3% | | | | |
| Five years later | 69.8% | 77.1% | 86.3% | 96.1% | 101.6% | 88.5% | | | | | |
| Six years later | 74.6% | 81.8% | 92.5% | 99.0% | 107.0% | | | | | | |
| Seven years later | 77.1% | 85.8% | 94.9% | 102.4% | | | | | | | |
| Eight years later | 79.8% | 88.2% | 97.4% | | | | | | | | |
| Nine years later | 81.6% | 90.0% | | | | | | | | | |
| Ten years later | 82.7% | | | | | | | | | | |
| Net liability re-estimate as of: | | | | | | | | | | | |
| One year later | 91.3% | 93.0% | 96.6% | 97.5% | 125.7% | 102.4% | 99.7% | 96.5% | 93.3% | 89.9% | |
| Two years later | 87.3% | 92.0% | 96.7% | 119.1% | 129.1% | 105.1% | 100.6% | 93.2% | 87.6% | | |
| Three years later | 86.7% | 91.9% | 111.9% | 120.3% | 133.1% | 106.9% | 98.8% | 91.0% | | | |
| Four years later | 87.0% | 102.0% | 111.5% | 123.2% | 136.1% | 106.2% | 98.5% | | | | |
| Five years later | 92.6% | 101.4% | 115.6% | 126.7% | 135.6% | 107.1% | | | | | |
| Six years later | 92.9% | 106.1% | 118.5% | 127.9% | 138.2% | | | | | | |
| Seven years later | 96.1% | 108.9% | 120.0% | 128.9% | | | | | | | |
| Eight years later | 98.0% | 110.5% | 121.5% | | | | | | | | |
| Nine years later | 99.5% | 111.9% | | | | | | | | | |
| Ten years later | 100.9% | | | | | | | | | | |
| Cumulative redundancy (deficiency) | $ (1.8) | $ (23.2) | $ (44.1) | $ (64.1) | $ (90.5) | $ (36.3) | $ 8.7 | $ 56.4 | $ 81.2 | $ 71.7 | |
| Cumulative redundancy (deficiency) | (0.9%) | (11.9%) | (21.5%) | (28.9%) | (38.2%) | (7.1%) | 1.5% | 9.0% | 12.4% | 10.1% | |
| Gross* liability end of year | $ 410.7 | $ 402.7 | $ 414.2 | $ 438.7 | $ 457.2 | $ 743.7 | $ 862.4 | $ 934.0 | $ 1,006.4 | $ 1,111.1 | $ 1,032.7 |
| Reinsurance recoverable | $ 211.2 | $ 208.5 | $ 209.2 | $ 217.0 | $ 220.5 | $ 233.8 | $ 270.3 | $ 305.2 | $ 350.5 | $ 399.8 | $ 371.7 |
| Net liability end of year | $ 199.5 | $ 194.2 | $ 205.0 | $ 221.7 | $ 236.7 | $ 509.9 | $ 592.1 | $ 628.8 | $ 655.9 | $ 711.3 | $ 661.0 |
| Gross liability re-estimated latest | 98.6% | 106.0% | 116.4% | 117.5% | 123.7% | 106.5% | 98.7% | 93.1% | 90.4% | 91.9% | |
| Reinsurance recoverable re-estimated latest | 96.3% | 100.4% | 111.5% | 105.8% | 108.2% | 105.2% | 99.2% | 97.4% | 95.5% | 95.3% | |
| Net liability re-estimated latest | 100.9% | 111.9% | 121.5% | 128.9% | 138.2% | 107.1% | 98.5% | 91.0% | 87.6% | 89.9% | |

* Gross liability includes: Direct and assumed losses and loss expenses payable.

As the Pooling Arrangement provides for the right of offset, we have reported losses and loss expenses payable ceded to our parent company as assets only in situations when net amounts ceded to our parent company exceed that assumed. The following table provides a reconciliation of the reinsurance recoverable to the amount reported in our consolidated financial statements at each balance sheet date:

| *($ millions)* | Years Ended December 31 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** |
| Reinsurance recoverable | $ 211.2 | $ 208.6 | $ 209.2 | $ 217.1 | $ 220.5 | $ 233.8 | $ 270.3 | $ 305.2 | $ 350.5 | $ 399.8 | $ 371.7 |
| Amount netted against assumed from State Auto Mutual | $ 196.9 | $ 195.3 | $ 197.7 | $ 206.3 | $ 212.6 | $ 219.9 | $ 261.5 | $ 291.0 | $ 324.6 | $ 382.4 | $ 358.2 |
| Net reinsurance recoverable | $ 14.3 | $ 13.3 | $ 11.5 | $ 10.8 | $ 7.9 | $ 13.9 | $ 8.8 | $ 14.2 | $ 25.9 | $ 17.4 | $ 13.5 |

Table of Contents

**Reinsurance**

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.

Each member of the State Auto Group is party to working reinsurance treaties for property, casualty and workers compensation lines with several reinsurers arranged through a reinsurance intermediary. Under the property per risk excess of loss treaty, each member is responsible for the first $3.0 million of each covered loss, and the reinsurers are responsible for 100% of the excess over $3.0 million up to $20.0 million of covered loss. The rates for this reinsurance are negotiated annually.

The terms of the casualty excess of loss program provide that each company in the State Auto Group is responsible for the first $2.0 million of a covered loss. The reinsurers are responsible for 95% of the excess over $2.0 million up to $5.0 million of covered loss. Also, certain unusual claim situations involving bodily injury liability, property damage, uninsured motorist and personal injury protection are covered by an arrangement that provides for $10.0 million of coverage in excess of $5.0 million retention for each loss occurrence. This layer of reinsurance sits above the $3.0 million excess of $2.0 million arrangement. The rates for this reinsurance are negotiated annually.

The terms of the workers compensation excess of loss program provide that each company in the State Auto Group is responsible for the first $2.0 million of covered loss. The reinsurers are responsible for 100% of the excess over $2.0 million up to $10.0 million of covered loss. Net retentions under this contract may be submitted to the casualty excess of loss program, subject to a limit of $2.0 million per loss occurrence. The rates for this reinsurance are negotiated annually.

In addition to the workers compensation reinsurance program described above, each company in the State Auto Group is party to an agreement which provides an additional layer of excess of loss reinsurance for workers compensation losses involving multiple workers. Subject to $10.0 million of retention, reinsurers are responsible for 100% of the excess over $10.0 million up to $20.0 million of covered loss. This coverage is subject to a Maximum Any One Life limit of $10.0 million. The rates for this reinsurance are negotiated annually.

In addition, the State Auto Group has secured other reinsurance to limit the net cost of large loss events for certain types of coverage. Included are umbrella liability losses which are reinsured up to a limit of $10.0 million with a maximum $0.6 million retention. The State Auto Group also makes use of facultative reinsurance for unique risk situations and participates in involuntary pools and associations in certain states.

Members of the State Auto Group maintain property catastrophe reinsurance for catastrophic events affecting at least two risks. On a combined basis, the members of the State Auto Group retain the first $55.0 million of catastrophe loss, each occurrence, with a 5% co-participation on the next $80 million of covered loss, each occurrence. The reinsurers are responsible for 95% of the excess over $55.0 million up to $135.0 million of covered losses, each occurrence. The rates for this reinsurance are negotiated annually.

Excess of the property catastrophe reinsurance described immediately above, the members of the State Auto Group participate in an intercompany catastrophe reinsurance program (the Catastrophe Assumption Agreement ). Under the terms of the Catastrophe Assumption Agreement our subsidiary, State Auto P&C, acts as the catastrophe reinsurer for the State Auto Group, and is responsible for up to $100.0 million of covered loss, each occurrence in excess of $135.0 million of covered loss, each occurrence. Each reinsured company pays a premium to our subsidiary, State Auto P&C, in exchange for the reinsurance coverage provided. There have been no losses assumed under this agreement.

Table of Contents

In 2005, we entered into a credit agreement with a financial institution and a syndicate of other lenders which provides us with a $100.0 million five-year unsecured revolving credit facility referred to as the Credit Facility . During the term of the Credit Facility, we have the right to increase the total facility amount by $25.0 million, up to a maximum total facility amount of $125.0 million, provided that no event of default has occurred and is continuing. The Credit Facility is available for general corporate purposes, including working capital and acquisitions, and for catastrophic loss purposes. At the present time, we intend to use the Credit Facility for catastrophe loss purposes. See Item 7 of this Form 10-K, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources, for additional information regarding the Credit Facility.

As of July 1, 2005, SA National and State Auto Mutual terminated their reinsurance agreement. While this reinsurance agreement was in effect, State Auto Mutual assumed up to $4.95 million of each liability loss occurrence in excess of SA National s $50,000 of retention and up to $450,000 of each catastrophe loss occurrence in excess of SA National s $50,000 of retention. State Auto Mutual also provided SA National with an 8.5% quota share within the $50,000 retention on liability coverages and a 20% quota share on physical damage coverages. SA National and State Auto Mutual mutually agreed to terminate the reinsurance agreement because of SA National s stronger surplus position, relative to the commencement date of the agreement, which makes it more efficient for SA National to retain such exposures rather than to reinsure them. Under the terms of the termination, State Auto Mutual continued to be liable, for up to one year, with respect to policies in force at the termination date, for occurrences until the expiration, cancellation, or next anniversary of each such policy.

See Narrative Description of Business Regulation of this Item 1 for a discussion of the Terrorism Risk Insurance Act of 2002 (the TRIA ) and its successor, the Terrorism Risk Insurance Extension Act of 2005 ( TRIEA ) (collectively, the Terrorism Acts ).

**Regulation**

Most states, including all the domiciliary states of the State Auto Group, have enacted legislation that regulates insurance holding company systems. Each insurance company in our holding company system is required to register with the insurance supervisory agency of its state of domicile and furnish information concerning the operations of companies within our holding company system that may materially affect the operations, management or financial condition of the insurers within the system. Pursuant to these laws, the respective insurance departments may examine any members of the State Auto Group, at any time, require disclosure of material transactions involving insurer members of our holding company system, and require prior notice and an opportunity to disapprove of certain extraordinary transactions, including, but not limited to, extraordinary dividends to stockholders. Pursuant to these laws, all transactions within our holding company system affecting any members of the State Auto Group must be fair and equitable. In addition, approval of the applicable Insurance Commissioner is required prior to the consummation of transactions affecting the control of an insurer. The insurance laws of all the domiciliary states of the State Auto Group provide that no person may acquire direct or indirect control of a domestic insurer without obtaining the prior written approval of the state insurance commissioner for such acquisition.

In addition to being regulated by the insurance department of its state of domicile, each of our insurance companies is subject to supervision and regulation in the states in which we transact business. Such supervision and regulation relate to numerous aspects of an insurance company s business operations and financial condition. The primary purpose of such supervision and regulation is to ensure financial stability of insurance companies for the protection of policyholders. The laws of the various states establish insurance departments with broad regulatory powers relative to granting and revoking licenses to transact business, regulating trade practices, licensing agents, approving policy forms, setting reserve requirements, determining the form and content of required statutory financial statements, prescribing the types and amount of investments permitted and requiring minimum levels of statutory capital and surplus. Although premium rate regulation varies among states and lines of insurance, such regulations generally require approval of the regulatory authority prior to any changes in rates. In addition, all of the states in which the State Auto Group transacts business have enacted laws which restrict

Table of Contents

these companies underwriting discretion. Examples of these laws include restrictions on policy terminations, restrictions on agency terminations and laws requiring companies to accept any applicant for automobile insurance. These laws may adversely affect the ability of the insurers in the State Auto Group to earn a profit on their underwriting operations.

We are required to file detailed annual reports with the supervisory agencies in each of the states in which we do business, and our business and accounts are subject to examination by such agencies at any time.

There can be no assurance that such regulatory requirements will not become more stringent in the future and have an adverse effect on the operations of the State Auto Group.

*Dividends*. Our insurance subsidiaries generally are restricted by the insurance laws of our respective states of domicile as to the amount of dividends we may pay without the prior approval of our respective state regulatory authorities. Generally, the maximum dividend that may be paid by an insurance subsidiary during any year without prior regulatory approval is limited to the greater of a stated percentage of that subsidiary s statutory surplus as of a certain date, or adjusted net income of the subsidiary for the preceding year. Under current law, a total of $140.8 million is available for payment as a dividend from our subsidiaries, State Auto P&C, Milbank, Farmers, SA Ohio and SA National during 2007, less dividend payments made in the previous twelve month period without prior approval from our respective domiciliary state insurance departments. STFC received no dividends in 2006 from its insurance subsidiaries. In 2005 and 2004, STFC received dividends of $40.5 million and $12.0 million respectively, from its insurance subsidiaries.

*Rates and Related Regulation*. Except as discussed below, we are not aware of the adoption of any adverse legislation or regulation in any state in which we conducted business during 2006 which would materially impact our business.

During an emergency session in January 2007, the Florida legislature passed and the Governor signed into law a bill known as CS/HB-1A. This new law makes fundamental changes to the property and casualty insurance business in Florida and undertakes a multi-pronged approach to address the cost of residential property insurance in Florida. First, the new law requires insurance companies to lower their Florida premium rates for residential property insurance. The new law also authorizes the state-owned insurance company, Citizens Property Insurance Corporation ( Citizens ), to reduce its premium rates and begin competing against private insurers in the residential property insurance market and expands the authority of Citizens to write commercial insurance. Previously, Citizens was the insurer of last resort for residential property insurance because its required premium rates were higher than those generally available in the market place from private insurers. The new law also empowers the State of Florida to assess Citizens underwriting losses against many lines of property and casualty insurance written for Florida residents, including auto insurance. The State of Florida also issued an order that essentially prevents insurance companies from non-renewing residential property insurance policies until after the 2007 hurricane season. We are evaluating the ramifications of CS/HB-1A, specifically regarding property insurance rates that we believe are inadequate to cover the related underwriting risk. Additionally, we are concerned about competing against a state-owned insurance company and the expansion of this possible type of solution to other states where the affordability and, in some instances, the availability of coastal property insurance is an issue. When the cost or availability of insurance becomes a political issue, we believe it can disrupt the marketplace and make underwriting results more volatile.

Several states where we write business have passed or are considering more strict regulation of the use of credit scoring in rating and/or risk selection in personal lines of business. Similarly, several states are considering restricting insurers rights to use loss history information maintained in various databases by insurance support organizations. These tools help us price our products more fairly and enhance our ability to compete for business that we believe will be profitable. Such regulations would limit our ability, as well as the ability of all other insurance carriers operating in any affected jurisdiction, to take advantage of these tools. Insurer use of credit scores is also being studied by the Federal Trade Commission, as respects to whether or not credit scoring has a disparate impact on protected classes. The results of this study, which have not been published as of our filing of this Form 10-K, could affect the industry s use of this tool.

Table of Contents

In an attempt to make capital and surplus requirements more accurately reflect the underwriting risk of different lines of insurance, as well as investment risks that attend insurers operations, the National Association of Insurance Commissioners ( NAIC ) annually tests insurers risk-based capital requirements. As of December 31, 2006, each insurer affiliated with us surpassed all standards tested by the formula applying risk-based capital requirements.

The property and casualty insurance industry is also affected by court decisions. In general, premium rates are actuarially determined to enable an insurance company to generate an underwriting profit. These rates contemplate a certain level of risk. The courts may modify, in a number of ways, the level of risk which insurers had expected to assume, including eliminating exclusions, expanding the terms of the contract, multiplying limits of coverage, creating rights for policyholders not intended to be included in the contract and interpreting applicable statutes expansively to create obligations on insurers not originally considered when the statute was passed. Courts have also undone legal reforms passed by legislatures, which reforms were intended to reduce a litigant s rights of action or amounts recoverable and so reduce the costs borne by the insurance mechanism. These court decisions can adversely affect an insurer s profitability. They also create pressure on rates charged for coverages adversely affected, and this can cause a legislative response resulting in rate suppression that can unfavorably impact an insurer.

The Terrorism Acts require the federal government and the insurance industry to share in insured losses up to $100 billion per year resulting from future terrorist attacks within the United States. Under the Terrorism Acts, commercial property and casualty insurers must offer their commercial policyholders coverage against certified acts of terrorism, but the policyholders may choose to reject this coverage. If the policyholder rejects coverage for certified acts of terrorism, we intend, subject to the approval of the state regulators, to cover only such acts of terrorism that are not certified acts under Terrorism Acts and that do not arise out of nuclear, biological or chemical agents. In December 2005, Congress enacted the TRIEA, which extended TRIA, with some modifications, for two years beyond TRIA s sunset date of December 31, 2005. This law removed the mandate to offer terrorism coverage for five lines of business: commercial auto, burglary and theft, surety, professional liability and farmowners multi-peril. In addition, TRIEA had the effect of increasing insurers deductible and co-pay percentages under this federal program. Our current property reinsurance treaties exclude certified acts of terrorism. If the Terrorism Acts expire at the end of 2007 those treaties may be revised to exclude acts of terrorism as defined within the treaties. Likewise, if the Terrorism Acts expire, we may pursue changes to our direct commercial policies to exclude acts of terrorism as defined within our policies.

An area of regulatory focus in recent years and which may continue to receive additional attention in 2007 is producer compensation arrangements. The New York Attorney General as well as other states Attorneys General undertook investigations and initiated lawsuits involving allegations of improper compensation arrangements between brokers and insurance companies. These actions led several state insurance departments to initiate their own surveys or inquiries into the activities of their domestic insurers with respect to producer compensation arrangements in their respective states. Three state insurance departments delivered inquiries to us, and we responded to each of the inquiries. It is our understanding that these inquiries were part of an overall fact-finding process initiated by these state insurance departments, and that similar inquiries were made to a number of other domestic insurers in these states. The inquiries did not indicate or imply that we had done anything improper with respect to our compensation arrangements with our agents. No action has been taken against us by any of the states which made these inquiries.

Improper producer compensation arrangements generally involve insurance brokers, who are persons retained and compensated by the insurance customer. We market our insurance products through independent insurance agents who have been appointed to act on our behalf, and we, not the insurance customer, compensate these agents pursuant to contractual arrangements. Under our agency agreements, our compensation arrangements with our agencies consist of commissions paid for the sale of our insurance products, usually based upon a percentage of the premium paid by the insurance customer, and a contingent commission. This contingent commission is based upon the underwriting profit and production volume generated by that

Table of Contents

agency s book of business placed with the State Auto Group. Like many other sales organizations, we also offer sales incentives to our agencies. We believe that our agent compensation arrangements are in compliance with the law and consistent with good business practices.

The Attorneys General of New York, Illinois and Connecticut settled producer compensation issues with some insurers we compete against and these settlements included an obligation for these insurers to terminate contingent commission compensation with their agents and brokers under certain circumstances. One such circumstance was a determination by the Attorneys General party to these settlements that companies with at least a 65% market share of property casualty insurance did not pay contingent commission. In the fall of 2006, that threshold was passed and two major insurers we compete against, Travelers and Chubb, announced their intention to terminate contingent commission compensation for agents and brokers in most lines of personal and business insurance, respectively, in compliance with the terms of the settlement agreement described above. This is a potentially significant development, the consequences of which cannot be fully foreseen at this time; nevertheless, we continue to believe that our agent compensation programs comply with applicable law.

**Investments**

Our investment portfolio is managed to provide growth of statutory surplus in order to facilitate increased premium writings over the long term while maintaining the ability to service current insurance operations. The primary objectives are to generate income, preserve capital and maintain liquidity. Our investment portfolio is managed separately from that of our parent company and its subsidiaries, and investment results are not shared by our Pooled Companies through the Pooling Arrangement. Stateco performs investment management services for us and our parent company and our subsidiaries, although investment policies implemented by Stateco continue to be set for each company through the Investment Committee of our Board of Directors.

Our decision to make a specific investment is influenced primarily by the following factors: (a) investment risks; (b) general market conditions; (c) relative valuations of investment vehicles; (d) general market interest rates; (e) our liquidity requirements at any given time; and (f) our current federal income tax position and relative spread between after tax yields on tax-exempt and taxable fixed income investments. We have investment policy guidelines with respect to purchasing fixed income investments for our insurance subsidiaries which preclude investments in bonds that are rated below investment grade by a recognized rating service. Our maximum investment in any single note or bond is limited to 5.0% of statutory assets, other than obligations of the U.S. government or government agencies, for which there is no limit. Investments in equity securities are selected based on their potential for appreciation as well as ability to continue paying dividends. See Item 7 of our Form 10-K, Management s Discussion and Analysis of Financial Condition and Results of Operations Other Investments, Market Risks, for a discussion regarding the market risks related to our investment portfolio.

Our fixed maturity investments are classified as available-for-sale and carried at fair value, according to the Financial Accounting Standards Board ( FASB ) Statement 115, Accounting for Certain Investments in Debt and Equity Securities ( SFAS 115 ).

Our Investment Policy and Guidelines permit investment in debt issues rated A or better by two major rating services. Our fixed maturities portfolio is composed of high quality, investment grade issues, comprised almost entirely of debt issues rated AAA or AA. As of December 31, 2006 and 2005, our bond portfolio had a fair value that totaled $1,647.4 million and $1,617.3 million, respectively.

At December 31, 2006 and 2005, our equity portfolio was classified as available-for-sale and carried at fair value totaling $284.2 million and $255.6 million, respectively.

Table of Contents

The following table sets forth our investment results for the periods indicated:

| | Year ended December 31 | | |
|---|---|---|---|
| *($ millions)* | **2006** | 2005 | 2004 |
| Average Invested Assets[1] | **$ 1,891.6** | $ 1,811.6 | 1,591.8 |
| Net Investment Income[2] | **83.1** | 78.7 | 71.8 |
| Average Yield | **4.4%** | 4.3% | 4.5% |

(1) Average of the aggregate invested assets at the beginning and end of each period, including interim quarter ends. Invested assets include fixed maturities at amortized cost, equity securities at cost, other invested assets at cost and cash equivalents.

(2) Net investment income is net of investment expenses and does not include realized or unrealized investment gains or losses or provision for income taxes.

For additional discussion regarding our investments, see Item 7 of our Form 10-K, Management s Discussion and Analysis of Financial Condition and Results of Operations Other Investments.

**Competition**

The property and casualty insurance industry is highly competitive. We compete with numerous insurance companies, many of which are substantially larger and have considerably greater financial resources. In addition, because our products are marketed exclusively through independent insurance agencies, most of which represent more than one company, we face competition within each agency. See Narrative Description of Business Marketing in Item 1 and Distribution System and Competition included Item 1A of our Form 10-K. We compete through underwriting criteria, appropriate pricing, quality service to our policyholders and our agents, and a fully developed agency relations program.

**Employees**

As of February 28, 2007, we had 2,060 employees. Our employees are not covered by any collective bargaining agreement. Management considers the relationship with our employees to be excellent.

**Available Information**

Our website address is www.stfc.com. Through this website (found under the SEC Filings link), we make available, free of charge, our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, proxy and information statements and all amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act ), as soon as reasonably practicable after we electronically file such material with the Securities and Exchange Commission (the SEC ). Also available on our website is information pertaining to our corporate governance, including the charters of each of our standing committees of our Board of Directors, our corporate governance guidelines, our employees code of business conduct and our directors ethical principles.

Any of the materials we file with the SEC may also be read and copied at the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. Information on the operation of the SEC s Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

**Table of Contents**

**Executive Officers of the Registrant**

| Name of Executive Officer and Position(s) with Company | Age[1] | Principal Occupation(s) During the Past Five Years | An Executive Officer of the Company Since[2] |
|---|---|---|---|
| Robert P. Restrepo, Jr., Chairman, President and Chief Executive Officer | 56 | Chairman of the Board and Chief Executive Officer of STFC and State Auto Mutual, 2/06 to present; President of STFC and Mutual, 3/06 to present; Senior Vice President, Insurance Operations, of Main Street America Group, a property and casualty insurance company, 4/05 2/06; President and Chief Executive Officer for two property and casualty insurance subsidiaries of Allmerica Financial Corporation (now known as Hanover Insurance Group), 1998 2003; President and Chief Executive Officer, personal lines, of Travelers Property and Casualty Insurance Company, a property and casualty insurance company, 1996 1998. | 2006 |
| Mark A. Blackburn, Executive Vice President and Chief Operating Officer | 55 | Executive Vice President and Chief Operating Officer of STFC and State Auto Mutual, 11/06 to present; Senior Vice President of STFC and State Auto Mutual, 3/01 to 11/06; Vice President of STFC and State Auto Mutual, 8/99 to 3/01. | 1999 |
| Steven E. English, Vice President and Chief Financial Officer | 46 | Vice President of STFC and State Auto Mutual, 5/06 to present; Chief Financial Officer of STFC and State Auto Mutual, 12/06 to present; Assistant Vice President of State Auto Mutual, 6/01 to 5/06; Chief Financial Officer and Treasurer of the MIGI Companies, 8/00 to 6/01. | 2006 |
| Steven R. Hazelbaker, Vice President | 51 | Vice President of State Auto Mutual, 6/01 to present; Vice President of STFC, 6/01 to present; Chief Operating Officer of the MIGI Companies, 8/00 to 6/01; Chief Financial Officer and Treasurer of the MIGI Companies, 1994 to 8/00; Vice President of the MIGI Companies, 1995 to 8/00. | 2001 |
| Noreen W. Johnson Vice President | 58 | Vice President of STFC and State Auto Mutual, 3/98 to present. | 2006 |
| Cathy B. Miley, Vice President | 57 | Vice President of STFC, 3/98 to present; Vice President of State Auto Mutual, 3/95 to present. | 1995 |
| Cynthia A. Powell, Vice President, Treasurer and Chief Accounting Officer | 46 | Treasurer and Chief Accounting Officer of STFC and State Auto Mutual, 6/06 to present; Vice President of State Auto Mutual, 3/00 to present; Vice President of STFC, 5/00 to present. | 2000 |
| Lorraine M. Siegworth, Vice President | 39 | Vice President of STFC and State Auto Mutual, 11/06 to present; Vice President of Nationwide Insurance or its affiliates, 9/00 to 3/06, most recently serving as Vice President of Corporate HR of Nationwide Insurance. | 2006 |

(1) Age is as of March 5, 2007.
(2) Each of the foregoing officers has been designated by our Board of Directors as an executive officer for purposes of Section 16 of the Exchange Act.

Table of Contents

**Item 1A. Risk Factors**

Statements contained in our Form 10-K may be forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are subject to certain risks and uncertainties that could cause our operating results to differ materially from those projected. The following factors, among others, in some cases have affected, and in the future could affect, our actual financial performance.

**RESERVES**

***If our estimated liability for losses and loss expenses is incorrect, our reserves may be inadequate to cover our ultimate liability for losses and loss expenses and may have to be increased.***

We establish and carry, as a liability, reserves based on actuarial estimates of how much we will need to pay in the future for claims incurred as of the end of the accounting period. We maintain loss reserves to cover our estimated ultimate unpaid liability for losses and loss expenses with respect to reported and unreported claims incurred as of the end of each accounting period. Reserves do not represent an exact calculation of liability, but instead represent estimates, generally using actuarial projection techniques at a given accounting date. These reserve estimates are expectations of what the ultimate settlement and administration of claims will cost based on our assessment of facts and circumstances then known, review of historical settlement patterns, estimates of trends in claims severity and frequency, legal theories of liability and other factors. Variables in the reserve estimation process can be affected by both internal and external events, such as changes in claims handling procedures, trends in loss costs, economic inflation, legal trends and legislative changes. Many of these items are not directly quantifiable, particularly on a prospective basis. Additionally, there may be a significant reporting lag between the occurrence of an insured event and the time it is actually reported to the insurer. We refine reserve estimates in a regular ongoing process as historical loss experience develops and additional claims are reported and settled. We record adjustments to reserves in the results of operations for the periods in which the estimates are changed. In establishing reserves, we take into account estimated recoveries for reinsurance and salvage and subrogation.

Because estimating reserves is an inherently uncertain process, currently established reserves may not be adequate. If we conclude the estimates are incorrect and our reserves are inadequate, we are obligated to increase our reserves. An increase in reserves results in an increase in losses and a reduction in our net income for the period in which the deficiency in reserves is identified. Accordingly, an increase in reserves could have a material adverse effect on our results of operations, liquidity and financial condition.

**CATASTROPHE LOSSES**

***The occurrence of catastrophic events could materially reduce our profitability.***

Our insurance operations expose us to claims arising out of catastrophic events. We have experienced, and will in the future experience, catastrophe losses that may cause substantial volatility in our financial results for any fiscal quarter or year and could materially reduce our profitability or harm our financial condition. Our ability to write new business also could be affected. Catastrophes can be caused by various natural events, including hurricanes, hailstorms, tornadoes, windstorms, earthquakes, severe winter weather and fires, none of which are within our control. Catastrophe losses can vary widely and could significantly impact our results. The frequency and severity of catastrophes are inherently unpredictable.

The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophes are restricted to small geographic areas; however, hurricanes, earthquakes and other perils may produce significant damage in larger areas, especially those that are heavily populated. Although catastrophes can cause losses in a variety of our property and casualty lines, most of our catastrophe claims in the past have related to homeowners and farmowners, other personal

**Table of Contents**

lines, allied lines and commercial multi-peril coverages. The geographic distribution of our business subjects us to catastrophe exposure from tornadoes, hailstorms and earthquakes in the Midwest as well as catastrophe exposure from hurricanes in Florida and the Gulf Coast, southern coastal states and Mid-Atlantic regions. In the last three years, the largest catastrophe or series of catastrophes to affect STFC s results of operations in any one year were as follows: 2006 with losses that occurred in April from a series of tornadoes, hailstorms and windstorms that caused damage in several of our Midwest operating states resulting in approximately $51.8 million in pre-tax losses; 2005 with losses from hurricanes Katrina and Wilma resulting in approximately $41.7 million in pre-tax losses; and 2004 with losses from hurricanes Charley, Frances, Jean and Ivan resulting in approximately $39.6 million in pre-tax losses.

We believe that increases in the value and geographic concentration of insured properties and the effects of inflation could increase the severity of claims from catastrophic events in the future. In addition, states have from time to time passed legislation that has the effect of limiting the ability of insurers to manage catastrophe risk, such as legislation prohibiting insurers from withdrawing from catastrophe-prone areas. Although we attempt to reduce the impact on our business of a catastrophe by controlling concentrations of exposures in catastrophe prone areas and through the purchase of reinsurance covering various categories of catastrophes, reinsurance may prove inadequate if a major catastrophic loss exceeds the reinsurance limit, or an insurance subsidiary incurs a number of smaller catastrophes that, individually, fall below the subsidiary s retention level.

**UNDERWRITING**

***Our financial results depend primarily on our ability to underwrite risks effectively and to charge adequate rates to policyholders.***

Our financial condition, cash flows and results of operations depend on our ability to underwrite and set rates accurately for a full spectrum of risks, across a number of lines of insurance. Rate adequacy is necessary to generate sufficient premium to pay losses, loss adjustment expenses and underwriting expenses and to earn a profit.

Our ability to underwrite and set rates effectively is subject to a number of risks and uncertainties, including, without limitation:

- the availability of sufficient, reliable data;
- our ability to conduct a complete and accurate analysis of available data;
- our ability to timely recognize changes in trends and to project both the severity and frequency of losses with reasonable accuracy;
- uncertainties which are generally inherent in estimates and assumptions;
- our ability to project changes in certain operating expense levels with reasonable certainty;
- the development, selection and application of appropriate rating formulae or other pricing methodologies;
- our ability to innovate with new pricing strategies, and the success of those innovations on implementation;
- our ability to predict policyholder retention accurately;
- unanticipated court decisions, legislation or regulatory action;

unanticipated changes in our claim settlement practices;

changing driving patterns for auto exposures; changing weather patterns for property exposures;

changes in the medical sector of the economy;

unanticipated changes in auto repair costs, auto parts prices and used car prices;

impact of inflation and other factors on cost of construction materials and labor;

- our ability to monitor property concentration in catastrophe prone areas, such as hurricane, earthquake and wind/hail regions; and

- the general state of the economy in the states in which we operate.

Such risks may result in our rates being based on inadequate or inaccurate data or inappropriate assumptions or methodologies, and may cause our estimates of future changes in the frequency or severity of claims to be incorrect. As a result, we could under price risks, which would negatively affect our margins, or we could overprice risks, which could reduce our volume and competitiveness. In either event, our operating results, financial condition and cash flows could be materially adversely affected.

**REINSURANCE**

***Reinsurance may not be available or adequate to protect us against losses.***

We use reinsurance to help manage our exposure to insurance risks. The availability and cost of reinsurance are subject to prevailing market conditions, both in terms of price and available capacity, which can affect our business volume and profitability. Although the reinsurer is liable to us to the extent of the ceded reinsurance, we remain liable as the direct insurer on all risks reinsured. As a result, ceded reinsurance arrangements do not eliminate our obligation to pay claims. We are subject to credit risk with respect to our ability to recover amounts due from reinsurers. Reinsurance may not be adequate to protect us against losses and may not be available to us in the future at commercially reasonable rates. In addition, the magnitude of losses in the reinsurance industry resulting from catastrophes may adversely affect the financial strength of certain reinsurers, which may result in our inability to collect or recover reinsurance. Reinsurers also may reserve their right to dispute coverage with respect to specific claims. With respect to catastrophic or other loss, if we experience difficulty collecting from reinsurers or obtaining additional reinsurance in the future, we will bear a greater portion of the total financial responsibility for such loss, which could materially reduce our profitability or harm our financial condition.

**NONSTANDARD PERSONAL LINES AUTO MARKET**

***The nonstandard personal lines auto market may be shrinking due to refined segmentation by key competitors***

In recent years, we have experienced significant declines in our nonstandard auto premium, in terms of dollars and exposure units. While some of this decline was due to actions we undertook to improve the profitability of this segment, we perceive that key competitors have refined their rating segmentation, including increased utilization of multi-variate rating models, which we believe has resulted in a shrinking of the nonstandard auto market. With the introduction of sophisticated pricing tools by our competitors, and most recently by us with the introduction of our CustomFit product, the criteria for qualifying for the standard private passenger auto line is much broader, so that the standard auto segment may accommodate some insureds who, to this point, would have been nonstandard candidates only. Consequently, there is no assurance that the decline in revenues and net underwriting profits within our nonstandard auto lines will not continue as a result of the changes taking place in the nonstandard auto market and our own implementation of more inclusive marketing and underwriting programs in the standard auto lines.

**CYCLICAL NATURE OF THE INDUSTRY**

***The property and casualty insurance industry is highly cyclical, which may cause fluctuations in our operating results.***

The property and casualty insurance industry, particularly business insurance, has been historically characterized by periods of intense price competition due to excess underwriting capacity, as well as periods of shortages of underwriting capacity that result in higher prices and more restrictive contract and/or coverage terms. The periods of intense price competition may adversely affect our operating results, and the overall cyclicality of the industry may cause fluctuations in our operating results. In response to periods of intense price competition, our strategy with respect to our commercial lines business has been to adjust prices to allow for

Table of Contents

acceptable profit levels and to decline coverage in situations where pricing or risk would not result in acceptable returns. Accordingly, our commercial lines business tends to contract during periods of severe competition and price declines and expand when market pricing allows an acceptable return.

The personal lines businesses are characterized by an auto underwriting cycle of loss cost trends. Driving patterns, inflation in the cost of auto repairs and medical care and increasing litigation of liability claims are some of the more important factors that affect loss cost trends. Inflation in the cost of building materials and labor costs and demand caused by weather-related catastrophic events affect personal lines homeowners loss cost trends. Our Company and other personal lines insurers may be unable to increase premiums at the same pace as coverage costs increase. Accordingly, profit margins generally decline in periods of increasing loss costs.

**DISTRIBUTION SYSTEM**

***The independent agency system is the distribution system for our products, which may constrain our ability to grow at a comparable pace to our competitors that utilize multiple distribution channels.***

We market our insurance products through independent, non-exclusive insurance agents, whereas some of our competitors sell their insurance products through direct marketing techniques, the internet or captive insurance agents who sell products exclusively for one insurance company. The State Auto Group has supported the independent agency system as our sole distribution channel for the past 85 years. However, we recognize that the number of independent agencies in the industry has dramatically shrunk over the past several years due to agency purchases, consolidations, bankruptcies and agent retirements. We also recognize that it will be progressively more difficult to expand the number of independent agencies representing us. If we are unsuccessful in maintaining and increasing the number of agencies in our independent agency distribution system, our sales and results of operations could be adversely affected.

The agents that market and sell our products also sell products of our competitors. These agents may recommend our competitors products over our products or may stop selling our products altogether. Our strategy of not pursuing market share at prices that are not expected to produce a combined ratio that meets our goal of 96% or better can have the effect of making top line growth more difficult. When price competition is intense, this effect is exaggerated by the fact that our independent agent distribution force has products to sell from other carriers that may be more willing to lower prices to grow top line sales. Consequently, we must remain focused on attracting and retaining productive agents to market and sell our products. We compete for productive agents primarily on the basis of our financial position, support services, ease of doing business, compensation and product features. Although we make efforts to ensure that we have strong relationships with our independent agents and to persuade them to promote and sell our products, we may not be successful in these efforts. If we are unsuccessful in attracting and retaining these agents, our sales and results of operations could be adversely affected.

We also expect that there will be consequences from certain of our competitors eliminating contingent commissions to agents as a result of legal actions undertaken by certain states Attorneys General. It may be that these or other Attorneys General will pursue other insurers who are continuing to pay contingent commissions or it may be that these insurers will develop alternative compensation structures to replace contingent commissions that may be perceived as more attractive to independent agents, thus driving the marketplace to move in that direction. It may also be that these large insurers will seek to level the playing field for independent agent compensation by lobbying for regulatory or legal changes to prohibit or restrict so-called contingent commissions and other sales incentive compensation.

**REGULATION**

***Our business is heavily regulated, and changes in regulation may reduce our profitability and limit our growth.***

We are subject to extensive regulation in the states in which we conduct business. This regulation is generally designed to protect the interests of policyholders, as opposed to stockholders and other investors, and relates to authorization for lines of business, capital and surplus requirements, investment limitations,

Table of Contents

underwriting limitations, transactions with affiliates, dividend limitations, changes in control, premium rates and a variety of other financial and non-financial components of an insurance company s business. The NAIC and state insurance regulators are constantly reexamining existing laws and regulations, generally focusing on modifications to holding company regulations, interpretations of existing laws and the development of new laws.

From time to time, some states in which we conduct business have considered or enacted laws that may alter or increase state authority to regulate insurance companies and insurance holding companies. In other situations, states in which we conduct business have considered or enacted laws that impact the competitive environment and marketplace for property and casualty insurance. For example, Florida recently enacted legislation that requires us to charge rates for homeowners insurance that we believe are inadequate to cover the related underwriting risk. This same legislation authorizes a state-owned insurance company to reduce its premium rates and begin competing against private insurers in the Florida residential property insurance market.

Currently the federal government does not directly regulate the insurance business. However, in recent years the state insurance regulatory framework has come under increased federal scrutiny. Congress and some federal agencies from time to time investigate the current condition of insurance regulation in the United States to determine whether to impose federal regulation or to allow an optional federal charter, similar to banks. In addition, changes in federal legislation and administrative policies in several areas, including changes in the Gramm-Leach-Bliley Act, financial services regulation and federal taxation, can significantly impact the insurance industry and us.

We cannot predict with certainty the effect any enacted, proposed or future state or federal legislation or NAIC initiatives may have on the conduct of our business. Furthermore, there can be no assurance that the regulatory requirements applicable to our business will not become more stringent in the future or result in materially higher costs than current requirements. Changes in the regulation of our business may reduce our profitability, limit our growth or otherwise adversely affect our operations.

**CLAIM AND COVERAGE DEVELOPMENTS**

***Developing claim and coverage issues in our industry are uncertain and may adversely affect our insurance operations.***

As industry practices and legislative, judicial and regulatory conditions change, unexpected and unintended issues related to claims and coverage may develop. These issues could have an adverse effect on our business by either extending coverage beyond our underwriting intent or by increasing the number or size of claims. The premiums we charge for our insurance products are based upon certain risk expectations. When the legislative, judicial or regulatory authorities expand the burden of risk beyond our expectations, the premiums we previously charged or collected may no longer be sufficient to cover the risk, and we do not have the ability to retroactively modify premium amounts. Examples of these claims and coverage issues include:

- changes in interpretation of the named insured provision with respect to the uninsured/underinsured motorist coverage in commercial auto policies that broaden the definition of the named insured;

- a growing trend of plaintiffs targeting property and casualty insurers, including us, in purported class action litigation relating to claim-handling and other practices, particularly with respect to the handling of personal lines auto and homeowners claims; and

- increases in the number and size of water damage claims related to expenses for testing and remediation of mold conditions.

Class action lawsuits relating to property and casualty losses arising out of hurricane Katrina have been filed in Mississippi against several named insurers and dozens of unnamed insurers. To date, we have not been named as a defendant or served with process in any of these lawsuits. However, that situation could change in the future. Based on our understanding of the nature of these lawsuits, the plaintiffs are attempting to expand the scope of coverage available under their insurance policies making claims for an event that would otherwise not be covered by their insurance policies. The principal focus of these lawsuits, including one lawsuit being brought by the attorney general of Mississippi, is to have the insurer-defendants policies cover flood losses that are excluded under the typical property insurance policy. Because of the preliminary nature of these lawsuits, it cannot be determined to what extent, if any, such lawsuits will impact us, or even if we will be named as a defendant in these lawsuits.

Many of these issues are beyond our control. The effects of these and other unforeseen claims and coverage issues are extremely hard to predict and could materially harm our business and results of operations.

**TERRORISM**

***Terrorist attacks, and the threat of terrorist attacks, and ensuing events could have an adverse effect on us.***

Terrorism, both within the United States and abroad, and military and other actions and heightened security measures in response to these types of threats, may cause loss of life, property damage, reduced economic activity, and additional disruptions to commerce. Actual terrorist attacks could cause losses from insurance claims related to the property and casualty insurance operations of the State Auto Group, as well as a decrease in our stockholders equity, net income and/or revenue. The Terrorism Acts require the federal government and the insurance industry to share in insured losses up to $100 billion per year resulting from certain future terrorist attacks within the United States. Under the Terrorism Acts, we must offer our commercial policyholders coverage against certified acts of terrorism. If the policyholder rejects coverage for certified acts of terrorism, we intend, subject to the approval of the state regulators, to cover only such acts of terrorism that are not certified acts under the Terrorism Acts and that do not arise out of nuclear, biological or chemical agents. See Narrative Description of Business-Regulation of this Item 1 for a discussion of the Terrorism Acts.

In addition, some of the assets in our investment portfolio may be adversely affected by declines in the equity markets and economic activity caused by the continued threat of terrorism, ongoing military and other actions and heightened security measures. We cannot predict at this time whether and the extent to which industry sectors in which we maintain investments may suffer losses as a result of potentially decreased commercial and economic activity, or how any such decrease might impact the ability of companies within the affected industry sectors to pay interest or principal on their securities, or how the value of any underlying collateral might be affected.

**TECHNOLOGY**

***Our development of business insurance lines automated underwriting tools may not be successful or the benefits may not be realized.***

We are developing a business insurance lines automation system that will build upon the success we believe we have achieved through our personal lines netXpress system. Our netXpress allows agents to obtain personal lines rates for applicants on-line in real time and secure consumer reports required for rating or underwriting. This report availability enables our agents to offer a firm quote to a customer in real time at the point of sale. It is our intention to develop similar functionality for business insurance lines as we have in personal lines through netXpress.

While this represents a significant commitment of resources over the next 18 to 36 months, we believe it is vitally important to our ability to maintain our prospects in business lines. We cannot be sure that the development of this technology will be completed within the timeframe projected, or that it will be successful upon implementation. Additionally, because some of our competitors have already implemented or may be implementing similar types of underwriting tools, we may be competitively disadvantaged. A challenge during this development phase will be the utilization of today s technology in face of a constantly changing technological landscape. There can be no assurance that the development of today s technology for tomorrow s use will not result in our being competitively disadvantaged, especially among the larger national carriers that have greater financial and human resources than we.

Table of Contents

**INVESTMENTS**

***The performance of our investment portfolios is subject to investment risks.***

Like other property and casualty insurance companies, we depend on income from our investment portfolio for a significant portion of our revenues and earnings and are therefore subject to market risk and the risk that we will incur losses due to adverse changes in equity, interest, commodity or foreign currency exchange rates and prices. Our primary market risk exposures are to changes in interest rates and equity prices.

If the fixed-income or equity portfolios, or both, were to be impaired by market, sector or issuer-specific conditions to a substantial degree, our liquidity, financial position and financial results could be materially adversely affected. Under these circumstances, our income from these investments could be materially reduced, and declines in the value of certain securities could further reduce our reported earnings and capital levels. A decrease in value of our investment portfolio could also put our insurance subsidiaries at risk of failing to satisfy regulatory minimum capital requirements. If we were not at that time able to supplement our subsidiaries capital from STFC or by issuing debt or equity securities on acceptable terms, our business could be materially adversely affected. Also, a decline in market rates could cause the investments in our pension plans to decrease below the accumulated benefit obligation, resulting in additional expense and increasing required contributions to the pension plan.

In addition, both the fixed-income and the common equity portfolios are subject to risks inherent in the nation s and world s capital markets. The functioning of those markets, the values of the investments held by us and our ability to liquidate investments on favorable terms or short notice may be adversely affected if those markets are disrupted or otherwise affected by local, national or international events, such as power outages, system failures, wars or terrorist attacks or by recessions or depressions, a significant change in inflation expectations, a significant devaluation of governmental or private sector credit, currencies or financial markets and other factors or events.

**EMPLOYEES**

***Our ability to attract, develop and retain talented employees, managers and executives, and to maintain appropriate staffing levels, is critical to our success.***

Our success depends on our ability to attract, develop and retain talented employees, including executives and other key managers in a specialized industry. Our loss of certain key officers and employees or the failure to attract and develop talented new executives and managers could have a materially adverse effect on our business.

In addition, we must forecast the changing business environments (for multiple business units and in many geographic markets) with reasonable accuracy and adjust hiring programs and/or employment levels accordingly. Our failure to recognize the need for such adjustments, or the failure or inability to react appropriately on a timely basis, could lead either to over-staffing (which would adversely affect our cost structure) or under-staffing (impairing our ability to service our ongoing and new business) in one or more business units or locations. In either event, our financial results could be materially adversely affected.

**BUSINESS CONTINUITY**

***Our business depends on the uninterrupted operation of our facilities, systems and business functions, including our information technology and other business systems.***

Our business is highly dependent upon our ability to perform, in an efficient and uninterrupted fashion, necessary business functions, such as Internet support and 24-hour claims contact centers, processing new and renewal business, and processing and paying claims. A shut-down of or inability to access one or more of our facilities, a power outage, a pandemic, or a failure of one or more of our information technology, telecommunications or other systems could significantly impair our ability to perform such functions on a timely basis. In addition, because our information technology and telecommunications systems interface with and depend on third party systems, we could experience service denials if demand for such service exceeds capacity

Table of Contents

or a third party system fails or experiences an interruption. If sustained or repeated, such a business interruption, systems failure or service denial could result in a deterioration of our ability to write and process new and renewal business, provide customer service, pay claims in a timely manner or perform other necessary corporate functions. This could result in a materially adverse effect on our business results and liquidity.

A security breach of our computer systems could also interrupt or damage our operations or harm our reputation. In addition, we could be subject to liability if confidential customer information is misappropriated from our computer systems. Despite the implementation of security measures, including hiring an independent firm to perform intrusion vulnerability testing of our computer infrastructure, these systems may be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. Any well-publicized compromise of security could deter people from entering into transactions that involve transmitting confidential information to our systems, which could have a material adverse effect on our business.

We have established a business continuity plan in an effort to ensure the continuation of core business operations in the event that normal business operations could not be performed due to a catastrophic event. While we continue to test and assess our business continuity plan to ensure it meets the needs of our core business operations and addresses multiple business interruption events, there is no assurance that core business operations could be performed upon the occurrence of such an event.

**ACQUISITIONS**

***Acquisitions subject us to a number of financial and operational risks.***

Since going public in 1991, we and State Auto Mutual have acquired other insurance companies, such as Meridian Mutual, the MIGI Insurers, Milbank, Farmers and SA Wisconsin, and it is anticipated that we and State Auto Mutual will continue to pursue acquisitions of other insurance companies in the future. In December 2006, State Auto Mutual, through MIGI, announced its intent to acquire the Beacon Insurance Group of Wichita Falls, Texas. A first quarter 2007 closing is anticipated, conditional upon regulatory approval.

Acquisitions involve numerous risks and uncertainties, such as:

- obtaining necessary regulatory approvals of the acquisition may prove to be more difficult than anticipated;
- integrating the acquired business may prove to be more costly than anticipated;
- integrating the acquired business without material disruption to existing operations may prove to be more difficult than anticipated;
- anticipated cost savings may not be fully realized (or not realized within the anticipated time frame);
- loss results of the company acquired may be worse than expected;
- losses may develop differently than what we expected them to; and
- retaining key employees of the acquired business may prove to be more difficult than anticipated.

In addition, other companies in the insurance industry have similar acquisition strategies. Competition for acquisitions may intensify or we may not be able to complete such acquisitions on terms and conditions acceptable to us. Additionally, the costs of unsuccessful acquisition efforts may adversely affect our financial performance.

**FINANCIAL STRENGTH RATINGS**

***A downgrade in our financial strength ratings may negatively affect our business.***

Insurance companies are subject to financial strength ratings produced by external rating agencies. Higher ratings generally indicate financial stability and a strong ability to pay claims. Ratings are assigned by rating agencies to insurers based upon factors that they believe are relevant to policyholders and creditors. Ratings are

Table of Contents

important to maintaining public confidence in our Company and in our ability to market our products. A downgrade in our financial strength ratings could, among other things, negatively affect our ability to sell certain insurance products, our relationships with agents, new sales and our ability to compete.

Although other agencies cover the property and casualty industry, we believe our ability to write business is most influenced by our rating from A.M. Best. According to A.M. Best, its ratings are designed to assess an insurer s financial strength and ability to meet ongoing obligations to policyholders. Our Pooled Companies and SA National currently have a rating from A.M. Best Company of A+ (Superior) (the second highest of A.M. Best s 15 ratings). We may not be able to maintain our current A.M. Best ratings.

**CONTROL BY OUR PARENT COMPANY**

***Our parent company owns a significant interest in us and may exercise its control in a manner detrimental to your interests.***

As of December 31, 2006, our parent company owned approximately 65% of the voting power of our Company. Therefore, State Auto Mutual has the power to direct our affairs and is able to determine the outcome of substantially all matters required to be submitted to stockholders for approval, including the election of all our directors. State Auto Mutual could exercise its control over us in a manner detrimental to the interests of other STFC stockholders.

**COMPETITION**

***Our industry is highly competitive, which could adversely affect our sales and profitability.***

The property and casualty insurance business is highly competitive, and we compete with a large number of other insurers. Many of our competitors have well-established national reputations, and substantially greater financial, technical and operating resources and market share than we. We may not be able to effectively compete, which could adversely affect our sales or profitability. We believe that competition in our lines of business is based primarily on price, service, commission structure, product features, financial strength ratings, reputation and name or brand recognition. Our competitors sell through various distribution channels, including independent agents, captive agents and directly to the consumer. We compete not only for business insurance customers and personal insurance customers, but also for independent agents to market and sell our products. Some of our competitors offer a broader array of products, have more competitive pricing or have higher claims paying ability ratings. In addition, other financial institutions are now able to offer services similar to our own as a result of the Gramm-Leach-Bliley Act.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

We share our operating facilities with State Auto Mutual pursuant to the terms of the 2005 Management Agreement. Our corporate headquarters are located in Columbus, Ohio, in buildings owned by State Auto Mutual that contain approximately 280,000 square feet of office space. Our Company and State Auto Mutual also own and lease other office facilities in numerous locations throughout the State Auto Group s geographical areas of operation.

**Item 3. Legal Proceedings**

We are a party to a number of lawsuits arising in the ordinary course of our insurance business. Our Management believes that the ultimate resolution of these lawsuits will not, individually or in the aggregate, have a material, adverse effect on our financial condition.

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

None.

Table of Contents

## PART II

### Item 5. Market for the Registrant s Common Equity, Related Shareholder Matters, and Issuer Purchases of Equity Securities

### Market Information; Holders of Record

Our common shares are traded in the NASDAQ National Market System under the symbol STFC. As of February 20, 2007, there were 3,835 stockholders of record of our common shares.

### Market Price Ranges and Dividends Declared on Common Shares[1]

Initial Public Offering June 28, 1991, $2.25. The following table provides information with respect to the high and low sale prices of our common shares for each quarterly period for the past two years as reported by NASDAQ, along with the amount of cash dividends declared by us with respect to our common shares for each quarterly period for the past two years:

| **2006** | High | Low | Dividend |
|---|---|---|---|
| First Quarter | **$ 39.94** | **$ 30.59** | **$ 0.090** |
| Second Quarter | **36.33** | **31.11** | **0.090** |
| Third Quarter | **32.90** | **28.40** | **0.100** |
| Fourth Quarter | **35.15** | **29.25** | **0.100** |

| 2005 | High | Low | Dividend |
|---|---|---|---|
| First Quarter | $ 28.43 | 24.30 | $ 0.045 |
| Second Quarter | 31.24 | 25.05 | 0.045 |
| Third Quarter | 32.63 | 28.22 | 0.090 |
| Fourth Quarter | 38.15 | 29.72 | 0.090 |

(1) Adjusted for stock splits.

Additionally, see Item 7 of our Form 10-K, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Regulatory Considerations, for additional information regarding regulatory restrictions on the payment of dividends by our insurance subsidiaries.

### Purchases of Common Shares by the Company

The following table provides information with respect to purchases made by us of our common shares during the fourth quarter 2006:

| Period | Total number of shares purchased[1] | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs |
|---|---|---|---|---|
| 10/01/06 - 10/31/06 | | $ | | |
| 11/01/06 - 11/30/06 | | | | |
| 12/01/06 - 12/31/06 | 408 | 34.05 | | |

| | | | |
|---|---|---|---|
| Total | 408 | $ | 34.05 |

[1] All shares repurchased were acquired as a result of stock swap option exercises.

Table of Contents

**Performance Graph**

The line graph below compares the total return on $100 invested on December 31, 2001, in STFC s shares, the CRSP Total Return Index for the NASDAQ Stock Market ( NASDAQ Index ), and the CRSP Total Return Index for NASDAQ insurance stocks ( NASDAQ Ins. Index ), with dividends reinvested.

Table of Contents

**Item 6. Selected Consolidated Financial Data**

| | Year ended December 31: | | | | |
|---|---|---|---|---|---|
| | **2006** | 2005* | 2004 | 2003 | 2002 |
| | *(dollars and shares in millions, except per share data)* | | | | |
| **Statement of Income Data** | | | | | |
| **GAAP Basis:** | | | | | |
| Earned premiums | **$ 1,023.8** | 1,050.3 | 1,006.8 | 960.6 | 896.6 |
| Net investment income | **$ 83.1** | 78.7 | 71.8 | 64.6 | 59.7 |
| Total revenues | **$ 1,117.4** | 1,139.5 | 1,092.4 | 1,041.7 | 967.5 |
| Net income | **$ 120.4** | 125.9 | 110.0 | 63.6 | 37.0 |
| Earned premium growth | **(2.5)%** | 4.3 | 4.8 | 7.1 | 61.5 |
| Return on average invested assets[(1)] | **4.4%** | 4.3 | 4.5 | 4.6 | 4.9 |
| **Balance Sheet Data** | | | | | |
| **GAAP Basis:** | | | | | |
| Total investments | **$ 1,937.9** | 1,879.9 | 1,699.1 | 1,570.3 | 1,272.3 |
| Total assets | **$ 2,255.1** | 2,274.9 | 2,168.4 | 2,029.9 | 1,706.8 |
| Total notes payable | **$ 118.4** | 118.7 | 164.5 | 161.2 | 75.5 |
| Total stockholders equity | **$ 834.2** | 763.5 | 658.2 | 542.3 | 463.8 |
| Common shares outstanding | **41.1** | 40.5 | 40.1 | 39.6 | 39.0 |
| Return on average equity[(2)] | **15.1%** | 17.7 | 18.3 | 12.6 | 8.6 |
| Debt to stockholders equity | **14.2%** | 15.5 | 25.0 | 29.7 | 16.3 |
| **Per Common Share Data** | | | | | |
| **GAAP Basis:** | | | | | |
| Basic EPS | **$ 2.95** | 3.12 | 2.76 | 1.62 | 0.95 |
| Diluted EPS | **$ 2.90** | 3.06 | 2.70 | 1.58 | 0.93 |
| Cash dividends per share | **$ 0.38** | 0.27 | 0.17 | 0.15 | 0.14 |
| Book value per share | **$ 20.32** | 18.86 | 16.42 | 13.71 | 11.89 |
| **Common Share Price:** | | | | | |
| High | **$ 39.94** | 38.15 | 31.83 | 26.90 | 17.25 |
| Low | **$ 28.40** | 24.30 | 22.12 | 14.96 | 12.67 |
| Close at December 31 | **$ 34.68** | 36.46 | 25.85 | 23.34 | 15.50 |
| Close price to basic EPS | **11.76x** | 11.69 | 9.37 | 14.41 | 16.32 |
| Close price to book value per share | **1.71x** | 1.93 | 1.57 | 1.70 | 1.30 |
| **GAAP Ratios:[(3)]** | | | | | |
| Loss and LAE ratio | **57.4%** | 58.4 | 61.5 | 67.8 | 72.9 |
| Expense ratio | **34.0%** | 31.7 | 30.2 | 30.4 | 29.5 |
| Combined ratio | **91.4%** | 90.1 | 91.7 | 98.2 | 102.4 |
| **Statutory Ratios:[(3)]** | | | | | |
| Loss and LAE ratio | **56.8%** | 58.4 | 61.6 | 67.9 | 73.1 |
| Expense ratio | **32.9%** | 31.6 | 30.6 | 30.7 | 29.2 |
| Combined ratio | **89.7%** | 90.0 | 92.2 | 98.6 | 102.3 |
| Industry combined ratio[(4)] | **93.3%** | 100.9 | 98.5 | 100.2 | 107.3 |
| Net premiums written to surplus[(5)] | **1.2** | 1.5 | 1.6 | 1.9 | 2.6 |

(1) Invested assets include investments and cash equivalents.

(2) Net income less preferred share dividends, if any, divided by average common stockholders equity.

(3) GAAP ratios are computed using earned premiums for both the loss and LAE ratio and the expense ratio, and include the effect of eliminations in consolidation. The statutory expense ratio is computed using net written premiums. We use the statutory combined ratio to compare our results to the industry statutory combined ratio as there is no industry GAAP combined ratio available.

(4) The industry combined ratios are from A.M. Best. The 2006 industry combined ratio is preliminary.

(5) 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 our statutory surplus available to absorb losses.

* Reflects change in Pooling Arrangement, effective January 1, 2005.

Table of Contents

**Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations**

Capitalized terms used in this Item 7 and not otherwise defined have the meanings ascribed to such terms under the caption Important Defined Terms Used in this Form 10-K which immediately precedes Part I of this Form 10-K.

**OVERVIEW**

State Auto Financial is a property and casualty insurance holding company primarily engaged in writing both personal and business lines of insurance. The State Auto Group writes a broad line of property and casualty insurance products through approximately 2,900 agencies in 28 states.

State Auto Financial s subsidiaries are State Auto P&C, Milbank, Farmers, SA Ohio and SA National, each of which is a property and casualty insurance company; Stateco, which provides investment management services to affiliated insurance companies; S.I.S., a developer and seller of insurance-related software; and 518 PML, which owns and leases property to affiliated companies. S.I.S and 518 PML are not material to our total operations.

State Auto Mutual owns approximately 65% of State Auto Financial s outstanding common shares. State Auto Mutual is one of only 14 companies in the United States to have been rated A+ (Superior) or higher by A.M. Best Company every year since 1954. State Auto Mutual s subsidiaries and affiliates are SA Florida and SA Wisconsin, each of which is a property and casualty insurance company; MIGI, an insurance holding company; Meridian Security, a property and casualty insurance company; and Meridian Citizens Mutual, a mutual property and casualty insurance company. Meridian Security and Meridian Citizens Mutual are collectively referred to as the MIGI Insurers and, together with MIGI, the MIGI Companies.

The Pooled Companies provide a broad line of property and casualty insurance, such as standard personal and commercial automobile, homeowners and farmowners, commercial multi-peril, workers compensation, general liability and property insurance. SA National provides nonstandard personal automobile insurance to the nonstandard insurance market.

Our Pooled Companies and SA National are rated A+ (Superior) by the A.M. Best Company.

The STFC Pooled Companies participate in a quota share reinsurance pooling arrangement (the Pooling Arrangement ) with the Mutual Pooled Companies. The Pooling Arrangement covers all the property and casualty insurance written by the Pooled Companies except voluntary assumed reinsurance written by State Auto Mutual, State Auto Middle Market Insurance (as defined in the current pooling agreement among the Pooled Companies) and intercompany catastrophe reinsurance written by State Auto P&C. Under the Pooling Arrangement, each of the Pooled Companies cedes premiums, losses and expenses on all of its business to State Auto Mutual, and State Auto Mutual in turn cedes to each of the Pooled Companies a specified portion of premiums, losses and expenses based on each of the Pooled Companies respective pooling percentages. State Auto Mutual then retains the balance of the pooled business. The participation percentage for the STFC Pooled Companies has remained at 80% since October 1, 2001.

As of January 1, 2005, the Pooling Arrangement was amended to add the MIGI Insurers as participants. In conjunction with this amendment, the STFC Pooled Companies received $54.0 million in cash from the MIGI Insurers which related to the additional net insurance liabilities assumed on January 1, 2005.

Table of Contents

The following table sets forth a chronology of the participant and participation percentage changes that have occurred in the Pooling Arrangement since January 1, 2004:

| | STFC Pooled Companies | | | | | Mutual Pooled Companies | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Year[1] | State Auto P&C | Milbank | Farmers | SA Ohio | *Sub Total* | State Auto Mutual | SA Wisconsin | SA Florida | Meridian Security | Meridian Citizens Mutual | *Sub Total* |
| 2004 | 59.0 | 17.0 | 3.0 | 1.0 | 80.0 | 18.3 | 1.0 | 0.7 | N/A | N/A | 20.0 |
| 2005 - 2006 | 59.0 | 17.0 | 3.0 | 1.0 | 80.0 | 19.5 | 0.0 | 0.0 | 0.0 | 0.5 | 20.0 |

[1] Time period is for the year ended December 31.

Prior to January 1, 2007, we operated in two significant reportable segments. State Auto P&C, Milbank, Farmers and SA Ohio comprised the standard segment of our operations, and SA National comprised the nonstandard segment. Under the leadership of Robert P. Restrepo, Jr., as our new Chairman, President and Chief Executive Officer, 2006 became a transitional year for the State Auto Group as we undertook initiatives to realign our internal organization, specifically our people, processes, internal reporting systems and compensation reward programs, to become more focused within the business and personal insurance markets. While 2007 will continue to be a transitional year in certain areas of our Company, we have now established integrated personal and business insurance teams with product, profit and production responsibilities for their respective areas. As a result of these transitional efforts, beginning in 2007, our significant reportable segments will be personal and business insurance along with a third segment for investment operations, and we will begin reporting on these bases to our chief operating decision makers. Financial information about our segments for 2006 is set forth in Note 15 to the Company s Consolidated Financial Statements included in Item 8 of the Form 10-K.

## EXECUTIVE SUMMARY

The results of our operations from year-to-year and quarter-to-quarter are primarily driven by our ability to generate revenue through selecting and pricing risks in a manner that permits premium growth without adversely affecting underwriting profits, and disciplined investment strategy. We also recognize that our results will be periodically impacted, sometimes significantly, by the occurrence of catastrophic events, which are generally beyond our control.

***Premium Growth/Underwriting Profitability:*** The property and casualty insurance industry is highly cyclical. Our industry has been historically characterized by periods of intense price competition due to excess underwriting capacity, as well as periods of shortages of underwriting capacity that result in increased prices and more favorable underwriting terms. During periods of excess underwriting capacity, some property and casualty insurers attempt to generate additional top line growth by setting their prices at levels inappropriate for the risk underwritten. While in the short term this may result in additional revenues, this action compromises their long term underwriting profitability. Our strategy is to adhere to disciplined and consistent underwriting principles. These principles include insistence on selecting and retaining business based on the merits of each account and a dedication to cost-based pricing, where each line of business is priced to generate a profit. It is our intention to set pricing levels so that no line of business, or classification within major lines, subsidizes another line or classification. We are committed to achieving our goal of a combined ratio of 96% or better through all market cycles, even at the expense of periodic slowdowns in written and earned premiums. We will not compromise underwriting profitability for top line growth. We believe that we can implement periodic rate changes in most states and remain an attractive market to our policyholders and independent agency partners by stressing the strengths we bring to the marketplace. These strengths include stability, financial soundness, prompt and fair claims service, and technology which makes it easier for the agent to do business with the State Auto Group and provide substantial value to our customers.

***Investment Strategy:*** We have a disciplined approach to our investment strategy that emphasizes the quality of our fixed income portfolio, which comprised 85% of our total portfolio at fair value at

30

Table of Contents

December 31, 2006, and includes only investment grade securities. Our equity portfolio, which comprised approximately 15% at fair value of our total portfolio at December 31, 2006, emphasizes large capitalization, dividend-paying companies. We select equity investments based on a stock s potential for appreciation as well as ability to continue paying dividends.

***Loss Reserves:*** We maintain reserves for the eventual payment of losses and loss expenses for both reported claims and incurred claims that have not yet been reported. Loss reserves are management s best estimates at a given point in time of what we expect to pay to claimants, based on facts, circumstances and historical trends then known. Although management uses many resources to calculate reserves, there is no precise method for determining the ultimate liability. We do not discount loss reserves for financial statement purposes. Our objective is to set reserves that are adequate such that the amounts that we originally record as reserves reasonably approximate the ultimate liability for insured losses and loss expenses. We then periodically review and adjust loss reserves on a timely basis. This ongoing periodic review assures a consistent level of adequacy and also minimizes the impact that any required adjustment may have on our current operating results.

***Catastrophic Events:*** We are exposed to claims arising out of catastrophic events. Catastrophe losses can and do cause substantial volatility in our financial results for any fiscal quarter or year. Catastrophes can be caused by various natural events, including hurricanes, hailstorms, tornadoes, windstorms, earthquakes, severe winter weather and fires, none of which are within our control. The frequency and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Many catastrophes are restricted to small geographic areas. However, hurricanes, earthquakes and other perils may produce significant damage in larger areas, especially those that are heavily populated. Although catastrophes can cause losses in a variety of our property and casualty lines, most of our catastrophe claims in the past have related to homeowners, other personal lines, allied lines and commercial multiple peril coverages. We deploy specific strategies designed to mitigate our exposure to catastrophe losses, which include obtaining reinsurance. We continually seek to diversify our business on a geographic basis. The number of states we operate in has increased from 17 states in 1991 to 28 states in 2007. In early 2007, we began writing personal insurance in the state of Colorado, our 28th state of operation. The concentration of gross written premiums for our property and casualty operations in our largest state, Ohio, has decreased from 28% for the year ended December 31, 1991, to 17.6% for the year ended December 31, 2006. We carefully monitor writing insurance in states that we believe present difficult legislative, judicial and/or regulatory environments for the insurance industry. Our underwriting guidelines are designed to limit exposures for high risk insurance matters such as asbestos and environmental claims. Our catastrophe management strategies are designed to mitigate our exposure to earthquakes and hurricanes.

In addition to our adherence to our cost-based pricing, investment and risk mitigation strategies, discussed above, our management focuses on several other key areas with the intention of continually improving the results of our operations and financial results, including the following:

***Claims Service:*** We believe an important element of our success is our focus on claims service. We expect our claim service to be fair, fast and friendly. The role of the claims division is to deliver the promise that we and the independent agent made to the insured. We have the capability of receiving claims 24 hours a day, seven days a week. Claims may be reported to our Claims Contact Center, to the policyholder s independent agent or via the Internet. We make a pledge to our policyholders to try and make contact with them within two hours of a claim being assigned to a claims handler (except in catastrophe loss situations).

***Independent Insurance Agent Network:*** We offer our products through approximately 2,900 agencies in 28 states. We believe the success of our independent insurance agent network, which is our only distribution channel, grows out of our commitment to promote and foster close working relationships with our agents. We seek relationships with agencies where we will be one of their top three insurers,

Table of Contents

measured on the basis of direct premiums written, for the type of business we desire. Our agents compensation package includes competitive commission rates and other sales inducements designed to maintain and enhance relationships with existing independent agents as well as to attract new independent agents. We provide our agents with a co-operative advertising program, sales training programs, an agent s stock purchase program, profit-sharing and travel incentives and agency recognition. We continually monitor our agencies for compatibility with us, taking into account factors such as loss ratio, premium volume, business profiles and relationship history. This allows us to be proactive in helping the agents to enhance profitability and, thus, maintain the advantages of the State Auto agency relationship. Our senior management regularly makes themselves available to the agency force to reinforce this partnership commitment. We believe each of these elements creates a relationship that has resulted in our independent insurance agents placing quality insurance business with us.

***Technology:*** Our internet-based point of sale agency portal for personal lines business, netXpress, and an automated intelligent underwriting system, Apollo, are examples of standards-based, user-friendly technology which improves the agents ease of doing business with us.

Statistics for 2006 indicate that 94% (up from 84% in 2005) of our personal automobile and homeowners new business applications were delivered to us electronically. This resulted in an additional 19,000 policies being sent to us electronically in 2006 over 2005. In regards to policy change requests, 78% were processed electronically by our agents in 2006 compared to 67% in 2005. This represents 32,000 more policy changes done electronically by agents in 2006 over 2005.

The Apollo system allows us to be better able to make consistent underwriting decisions across personal auto and homeowners products. In 2006, we expanded the use of this system to additional states, additional products, and added the automated review of claims transactions. In 2006, more than 282,000 transactions (new business, endorsements, cancellations, and claims transactions) were reviewed by Apollo. Of those, 174,000 of them were automatically accepted by business rules established within Apollo.

Management continued to focus in 2006 on improving our ease of doing business in other ways as well, such as enhancements to our electronic portal for agents, called AgentSite, and creating ways for our internet rating and underwriting systems to talk with more agency management systems and third party application tools that our agents use.

We added two new underwriting tools in 2006. Our youthful driver identification tool, which works to identify youthful operators at the earliest possible point without the need to rely on agents or policyholders, is now being used in nine of our nonstandard personal automobile insurance states and 11 of our standard personal automobile insurance states. Youthful operators, as inexperienced drivers, tend to produce a disproportionate number of losses. Our ability to identify these drivers early and charge the appropriate premium should improve our profitability on these accounts. We also introduced a property protection class tool in 20 states. This tool verifies the accuracy of the fire protection class for a given risk which will assist in providing more appropriate underwriting.

The AgentSite Dashboard was enhanced to provide agents with even quicker access to customer information and their recent transactions. This new functionality has helped agents transition following our decision to eliminate the printing and mailing of paper policy declarations to agents for personal insurance.

In 2006, we upgraded our enterprise billing and claims systems. Both of these applications now utilize browser- based technology which replaced older, hard to maintain technology. We also increased the methods by which insureds can make premium payments. Insureds can now pay online via our website portal and by credit and debit cards. All of these methods have resulted in increased flexibility and more satisfied customers. We also now receive nearly 15% of our new claims via our website portal.

In 2006, we began work to develop business insurance automation systems that are intended to build upon the success we have achieved through our netXpress system for personal insurance. We

Table of Contents

modernized our business insurance policy administration system to allow straight through processing which now results in a real time update capability. In order to achieve our goal of commercial lines functionality equivalent to that provided by netXpress in personal insurance, we are making necessary and appropriate investments in people and systems. We believe developing such an internet-based system is vitally important to our ability to compete for new business insurance accounts. The goal is to enable agents to offer a firm quote to a customer in real time at the point of sale for three of our major business insurance products.

**CRITICAL ACCOUNTING POLICIES**

Our significant accounting policies are more fully described in Note 1 of the Notes to our Consolidated Financial Statements included in Item 8 of this Form 10-K. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, revenues and expenses for the period then ended and the financial entries in the accompanying notes to the financial statements. Such estimates and assumptions could change in the future, as more information becomes known which could impact the amounts reported and disclosed therein. We have identified the policies and estimates described below as critical to our business operations and the understanding of the results of our operations.

***Investments***

Fixed maturity and equity security investments are classified as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are shown as a separate component of stockholders equity as accumulated other comprehensive income, and as such are not included in the determination of net income. Investment income is recognized when earned, and capital gains and losses are recognized when investments are sold.

We regularly monitor our investment portfolio for declines in value that are other-than-temporary, an assessment that requires significant management judgment. Among the factors management considers are the nature of the investment, severity and length of decline in fair value, events impacting the issuer, overall market conditions and its intent and ability to hold securities until the value recovers. 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. For a further discussion regarding our investments see Other Investments included herein.

***Deferred Acquisition Costs***

Acquisition costs, consisting of commissions, premium taxes and certain underwriting expenses relating to the production of property and casualty business, are deferred and amortized over the same period in which the related premiums are earned. The method followed for computing the acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premium to be earned, related investment income, losses and loss expenses expected to be incurred, and certain other costs expected to be incurred as premium is earned. These amounts are based on estimates, and accordingly, the actual realizable value may vary from the estimated realizable value.

***Losses and Loss Expenses Payable***

Losses and loss expenses payable are management s best estimates at a given point in time of what we expect to pay claimants, based on known facts, circumstances and historical trends. Reserves for reported losses are established on either a case-by-case or formula basis depending on the type and circumstances of the loss. The case-by-case reserve amounts are determined by claims adjusters based on our reserving practices, which take into account the type of risk, the circumstances surrounding each claim and policy provisions relating to types of loss. The formula reserves are based on historical data for similar claims with provision for trend changes caused by inflation. Case and formula basis loss reserves are reviewed on a regular basis, and as new data becomes available, estimates are updated resulting in adjustments to loss reserves. Generally, reported losses initially reserved on a formula basis and not settled after six months are case reserved at that time.

Loss and loss expense reserves for incurred claims that have not yet been reported (IBNR) are estimated based on many variables including historical and statistical information, inflation, legal developments, storm loss estimates, and economic conditions. The process for calculating IBNR is to develop an estimate of the ultimate losses incurred, and then subtract all amounts already paid or held in tabular case reserves. Although management uses many internal and external resources, as well as multiple established methodologies to calculate IBNR, there is no method for determining the exact ultimate liability. See further discussion regarding our losses and loss expense reserves and our reserving methods see Other Loss and Loss Expense Reserves included herein.

***Pension and Postretirement Benefit Obligations***

Pension and postretirement benefit obligations are long term in nature and require management s judgment in estimating the factors used to determine these amounts. Management reviews these factors annually, including the discount rate and expected long term rate of return on plan assets. Because these obligations are based on management estimates which could change, the ultimate benefit obligation could be different from the amount estimated. For a further discussion regarding our pension and postretirement benefit obligations see Other Employee Benefit Plans included herein.

***Share-Based Compensation***

We have share-based compensation plans which authorize the granting of various equity-based incentives including stock options, restricted stock and restricted share units to employees and non-employee directors and agents. The expense for these equity-based incentives is based on their fair value at date of grant or each reporting date and amortized over their vesting period. The fair value of each stock option granted is estimated on the date of grant or each reporting date using the Black-Scholes closed-form pricing model. The pricing model requires assumptions such as the expected life of the option and expected volatility of our stock over the expected life of the option, which significantly impacts the assumed fair value. We use historical data to determine these assumptions and if these assumptions change significantly for future grants, share-based compensation expense will fluctuate in future periods. For a discussion regarding our adoption of SFAS 123(R), Share-Based Payment ( SFAS 123(R) ), effective January 1, 2006, see 2006 Compared to 2005 Expenses included herein.

***Other***

Other items that could have a significant impact on the financial statements include the risks and uncertainties listed in Item 1A of this Form 10-K under Risk Factors. Actual results could differ materially using different estimates and assumptions, or if conditions are significantly different in the future.

Table of Contents

## RESULTS OF OPERATIONS

### Summary

The following table summarizes certain key performance indicators used to manage our operations for the years ended December 31, 2006, 2005 and 2004, respectively:

| *($ millions)* | **2006** | 2005 | 2004 |
|---|---|---|---|
| GAAP Basis: | | | |
| Total revenues | **$ 1,117.4** | 1,139.5 | 1,092.4 |
| Net income | **$ 120.4** | 125.9 | 110.0 |
| Stockholders equity[1] | **$ 834.2** | 763.5 | 658.2 |
| Book value per share[1] | **$ 20.32** | 18.86 | 16.42 |
| Loss and LAE ratio[2] | **57.4** | 58.4 | 61.5 |
| Expense ratio[2] | **34.0** | 31.7 | 30.2 |
| Combined ratio | **91.4** | 90.1 | 91.7 |
| Catastrophe loss and LAE points[2] | **8.9** | 6.9 | 7.0 |
| Premium written growth[3] | **(2.5)%** | 5.0 | 3.1 |
| Premium earned growth | **(2.5)%** | 4.3 | 4.8 |
| Investment yield | **4.4%** | 4.3 | 4.5 |
| Statutory Basis: | | | |
| Net premiums written to surplus[4] | **1.2** | 1.5 | 1.6 |

(1) For 2006, accumulated comprehensive income, a component of stockholders equity, was reduced by $63.9 million and book value per share by $1.56, respectively, for the initial impact of the adoption of SFAS 158 (defined below) at December 31, 2006. For a further discussion of the impact of SFAS 158, see Other Employee Benefit Plans included herein.

(2) See 2006 Compared to 2005 Expenses section below for a definition of catastrophes.

(3) 2.3 points of the increase for 2005 related to the $24.0 million of unearned premiums transferred to us in connection with the addition of the MIGI Insurers to the Pooling Arrangement.

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

---

Our reportable segments are standard insurance and nonstandard insurance. The profits of these segments are monitored by management without consideration of transactions with other segments or realized gains or losses on sales of investments.

The following table reflects segment profits (loss) for the years ended December 31, 2006, 2005 and 2004, respectively:

| *($ millions)* | **2006** | 2005 | 2004 |
|---|---|---|---|
| Standard insurance | **$ 157.7** | 168.7 | 141.5 |
| Nonstandard insurance | **9.4** | 9.1 | 10.2 |
| All other | **(0.7)** | 0.7 | 3.0 |
| *Total segment profit* | **$ 166.4** | 178.5 | 154.7 |

The reader is referred to the complete disclosure on reportable segments in Note 15, Reportable Segments, of the Notes to our Consolidated Financial Statements included in Item 8 of this Form 10-K.

---

A critical measure of a successful property and casualty insurance company is whether or not it consistently produces an underwriting profit during all market cycles. When underwriting is not profitable, insurance losses and related acquisition and operating expenses exceed premiums.

Sustained underwriting losses can place an insurer at greater risk of insolvency than an insurer which is consistently profitable from an underwriting standpoint. We have consistently focused on producing an underwriting profit and, therefore, we view our underwriting results during all market cycles as the most important measure of our overall operating performance.

Table of Contents

We monitor the performance of our insurance segments by concentrating on segment underwriting profit and combined ratio. Underwriting profit under Statutory Accounting Principles ( SAP ) is determined by subtracting from earned premiums, losses and loss expenses and net underwriting expenses incurred. SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. U.S. Generally Accepted Accounting Principles ( GAAP ), however, require the recognition of acquisition costs as the premiums are 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 herein. The GAAP Combined Ratio is defined as the sum of the GAAP loss and LAE ratio (loss and loss expenses, as a percentage of earned premiums) plus GAAP expense ratio (acquisition and operating expenses, as a percentage of earned premiums). When the combined ratio is less than 100%, the insurer is operating at an underwriting profit. When the combined ratio is greater than 100%, the insurer is operating at an underwriting loss.

The following tables provides a summary of the insurance segments GAAP underwriting profit (in dollars), GAAP Combined Ratio along with related segment net investment income, for the years 2006, 2005 and 2004, respectively. The tabular information provided is net of adjustments for transactions with other segments.

| *($ millions)* | 2006 | | | | | |
|---|---|---|---|---|---|---|
| | Standard | % Ratio | Nonstandard | % Ratio | Total | % Ratio |
| Written premiums | **$ 977.1** | | **$ 42.4** | | **$ 1,019.5** | |
| Earned premiums | **979.0** | | **44.8** | | **1,023.8** | |
| Losses and loss expenses | **560.7** | **57.3** | **26.9** | **60.0** | **587.6** | **57.4** |
| Acquisition and operating expenses | **336.9** | **34.4** | **11.1** | **24.7** | **348.0** | **34.0** |
| GAAP underwriting profit and combined ratio | **$ 81.4** | **91.7** | **$ 6.8** | **84.7** | **$ 88.2** | **91.4** |
| Net investment income | **$ 77.3** | | **$ 3.9** | | **$ 81.2** | |

| *($ millions)* | 2005 | | | | | |
|---|---|---|---|---|---|---|
| | Standard | % Ratio | Nonstandard | % Ratio | Total | % Ratio |
| Written premiums | $ 1,020.6(1) | | $ 48.9 | | $ 1,069.5(1) | |
| Earned premiums | 997.2 | | 53.1 | | 1,050.3 | |
| Losses and loss expenses | 579.2 | 58.1 | 34.2 | 64.4 | 613.4 | 58.4 |
| Acquisition and operating expenses | 321.2 | 32.2 | 11.7 | 22.1 | 332.9 | 31.7 |
| GAAP underwriting profit and combined ratio | $ 96.8 | 90.3 | $ 7.2 | 86.5 | $ 104.0 | 90.1 |
| Net investment income | $ 73.1 | | $ 4.1 | | $ 77.2 | |

| *($ millions)* | 2004 | | | | | |
|---|---|---|---|---|---|---|
| | Standard | % Ratio | Nonstandard | % Ratio | Total | % Ratio |
| Written premiums | $ 952.2 | | $ 65.9 | | $ 1,018.1 | |
| Earned premiums | 935.3 | | 71.5 | | 1,006.8 | |
| Losses and loss expenses | 568.8 | 60.8 | 50.4 | 70.5 | | |