State Auto Financial CORP
Form 10-K
March 14, 2008
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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, 2007 or

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

Commission File Number 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

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

(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code:

(614) 464-5000

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, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

As of June 30, 2007, 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 $443,201,023.

On March 7, 2008, the Registrant had 40,167,853 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 7, 2008 (the 2008 Proxy Statement), which will be filed within 120 days of December 31, 2007, are incorporated by reference into Part III of this Form 10-K.

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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 Insurance 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 64% 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) Meridian Citizens Mutual Insurance Company (Meridian Citizens Mutual), Beacon National Insurance Company (Beacon National), Patrons Mutual Insurance Company of Connecticut (Patrons Mutual), and Litchfield Fire Mutual Insurance Company (Litchfield), (State Auto Mutual, SA Florida, SA Wisconsin, Meridian Security, Meridian Citizens Mutual, Beacon National, Patrons Mutual and Litchfield are referred to as the Mutual Pooled Companies);

The MIGI Insurers refer to Meridian Security and Meridian Citizens Mutual, and the MIGI Companies refer to the MIGI Insurers and Meridian Insurance Group, Inc. (MIGI);

The Beacon Insurance Group or Beacon Group refers to Beacon National and Beacon Lloyds Insurance Company (Beacon Lloyds);

The Patrons Insurance Group or Patrons Group refers to Patrons Mutual, Litchfield, Patrons Fire Insurance Company of Rhode Island (Patrons Fire) and Provision State Insurance Company (Provision State); and

The "State Auto Group" refers to the Pooled Companies and the non-pooled insurance companies including SA National, Beacon Lloyds, Provision State and Patrons Fire.

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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.

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.

Our parent company is State Auto Mutual, an Ohio domiciled super-regional mutual property and casualty insurance company organized in 1921. It owns approximately 64% 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 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. MIGI also owns 100% of State Auto Holdings, Inc., an insurance holding company, which owns 100% of the Beacon Insurance Group. In March 2007, State Auto Mutual completed its purchase of the Beacon Insurance Group of Wichita Falls, Texas. With this acquisition, Texas became the State Auto Group s 29th state of operation. The Beacon Insurance Group is comprised of Beacon National and Beacon Lloyds, which are affiliated through a trust agreement. Beacon National and Beacon Lloyds wrote premiums during 2007 in Texas and Arkansas. In December 2007, State Auto Mutual completed its affiliation with the Patrons Insurance Group. This affiliation expanded the State Auto Group s operations to 33 states by adding Connecticut, Massachusetts, Rhode Island and Vermont.

State Auto P&C has participated in a quota share reinsurance pooling arrangement with State Auto Mutual 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. On January 1, 2008, Beacon National, Patrons Mutual and Litchfield became participants in the Pooling Arrangement. See Narrative Description of Business Pooling Arrangement in this Item 1 for further information regarding the Pooling Arrangement.

The State Auto Group markets 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 independent insurance agencies in 33 states. Our Pooled Companies and SA National are rated A+ (Superior) by the A.M. Best Company.

(b) Financial Information about Segments

We have three significant reportable segments: personal insurance and business insurance (the insurance segments), and investment operations. The insurance segments are managed separately because of the differences in types of customers served, products provided or services offered. In 2007, the insurance segments distributed their products through the independent agency system in 29 states. The personal insurance segment provides primarily personal auto (standard and nonstandard) and homeowners to the personal insurance market. The business insurance segment provides primarily commercial auto, commercial multi-peril, fire and allied lines, other and product liability and workers compensation insurance to small to medium sized businesses within the commercial insurance market, which in 2008 includes middle market business. The investment operations segment, managed by Stateco, provides investment services for our Company s invested assets.

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Prior to 2007, we reported our financial information in two segments, a standard insurance segment and a nonstandard insurance segment. We believe that our new segments better reflect the manner in which we manage our business and report our results internally to our principal operating decision makers. We established integrated personal and business insurance teams with product and profit responsibilities for their respective areas. We evaluate the performance of our insurance segments using industry financial measurements based on Statutory Accounting Principles (SAP), which include loss and loss adjustment expense ratios, underwriting expense ratios, combined ratios, statutory underwriting gain (loss), net premiums earned and net written premiums. Prior reporting periods have been restated to conform to the new segment presentation.

(c) Narrative Description of Business

Property and Casualty Insurance

Pooling Arrangement

Our Pooled Companies are parties to the Pooling Arrangement. In general, 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 2001. Prior to 2008, the Pooling Arrangement covered all property and casualty insurance written by the Pooled Companies except State Auto Mutual s voluntary assumed reinsurance, middle market business insurance written by State Auto Mutual and Meridian Security and intercompany catastrophe reinsurance written by State Auto P&C.

In 2008, we made the following changes to the Pooling Arrangement:

- Added Beacon National to the pool with a participation percentage of 0.0%;
- Added Patrons Mutual and Litchfield to the pool with participation percentages of 0.4% and 0.1%, respectively;
- Reduced State Auto Mutual s participation percentage from 19.5% to 19.0% to accommodate the participation percentages allocated to Patrons Mutual and Litchfield;
- Included State Auto middle market business insurance written by State Auto Mutual and Meridian Security.

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, 1997:

Year[1]	State Auto Mutual	State Auto P&C	Milbank	SA Wisconsin	Farmers	SA Ohio	SA Florida	Meridian Security	Meridian Citizens Mutual	Beacon National	Patrons Mutual	Litchfield Mutual
1997	55.0	35.0	10.0	N/A	N/A	N/A	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	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	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	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	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	N/A	N/A	N/A
1/1/2005 2007	19.5	59.0	17.0	0.0	3.0	1.0	0.0	0.0	0.5	N/A	N/A	N/A
1/1/2008 current	19.0	59.0	17.0	0.0	3.0	1.0	0.0	0.0	0.5	0.0	0.4	0.1

(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.

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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	State Auto Mutual Pooled Companies
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 current	80	20

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

It is not management s intention to recommend an adjustment to the STFC Pooled Companies 80% participation level in the foreseeable future. Under applicable governance procedures, if the 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 STFC. The Pooling Arrangement is terminable by any of our Pooled Companies at any time by any party by giving twelve months notice to the other parties and their respective domiciliary insurance departments. 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 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 Pooling Arrangement excludes catastrophic losses and loss adjustment expenses that are reinsured under our Catastrophe Assumption Agreement (defined below), 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 in the amount of $100.0 million in excess of $135.0 million. No losses were paid by State Auto P&C under the Catastrophe Assumption Agreement in 2007, 2006 or 2005. The State Auto Group does not currently intend to renew the Catastrophe Assumption Agreement upon its expiration on July 1, 2008. The State Auto Group is considering other alternatives, such as securing replacement coverage from a third party reinsurer or relying upon the $100 million set aside under the Credit Agreement (defined below) to fund this layer of catastrophe reinsurance, but currently no decision has been reached. See Narrative Description of Business Reinsurance in this Item 1 for further information regarding the Catastrophe Assumption Agreement.

Our nonstandard automobile programs, written through SA National, 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 the Pooling Arrangement. See Narrative Description of Business Marketing for further information regarding our nonstandard auto insurance business.

Management Agreement

With the exception of the Patrons Group (discussed below), our subsidiary, State Auto P&C, provides the employees to perform all organizational, operational and management functions for the State Auto Group and

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State Auto Mutual provides certain operating facilities, including our corporate headquarters, for the State Auto Group through management and cost sharing agreements. Each of the affiliated management and cost sharing agreements has a ten-year term and renews for an additional ten-year period unless terminated sooner in accordance with their terms. If our primary management agreement, which we refer to as our 2005 Management Agreement, were 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. See also Item 2 (Property) of this Form 10-K.

On December 14, 2007, State Auto Mutual and State Auto P&C became parties to various management and/or cost sharing agreements in conjunction with State Auto Mutual s affiliation with the Patrons Insurance Group. Each of these management and/or cost sharing agreements apportions among the parties the actual costs of the services provided. Employees of the Patrons Group will remain employees of Patrons Mutual until January 1, 2009, at which time it is expected that they will become employees of State Auto P&C. The insurance operations of the Patrons Group will continue to be conducted at facilities owned by Patrons Mutual and Litchfield.

Marketing

As of January 1, 2008, the State Auto Group marketed its products in 33 states through independent insurance agencies. None of the companies in the State Auto Group has any contracts with managing general agencies.

We view our independent insurance agents as our primary customers, because they are in a position to recommend either our insurance products or those of a competitor to their customers. We strongly support the independent agency system and believe its maintenance 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; contingent commissions; 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, as well as in our agents offices.

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 contingent commissions 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, we make available to our agents a stock purchase plan which provides them with the opportunity to

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use their commission income to purchase our stock. Our transfer agent administers this stock purchase plan using commission dollars assigned by the agents to purchase shares on the open market through a stockbroker. We also make available to our top performing agents a stock option plan which provides them with the opportunity to vest grants of options in our stock if they meet certain performance targets.

During 2007, the State Auto Group, which includes the Beacon and Patrons Groups, received premiums on products marketed in Alabama, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia and Wisconsin. During 2007, the eight states that contributed the greatest percentage of our direct premiums written were as follows: Ohio (17.1%), Kentucky (10.2%), Indiana (6.9%), Tennessee (6.3%), Pennsylvania (4.6%), Minnesota (4.6%), Maryland (4.4%) and Arkansas (4.1%).

Claims

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.

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 claim service 24 hours a day, seven days a week, 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.

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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.

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:

($ millions)	Year Ended December 31		
	2007	2006	2005
Beginning of Year:			
Loss and loss expenses payable	**$ 674.5**	728.7	681.8
Less: Reinsurance recoverable on losses and loss expenses payable(1)	**13.5**	17.4	25.9
Net losses and loss expenses payable(2)	**661.0**	711.3	655.9
Provision for losses and loss expenses occurring:			
Current year	**645.5**	659.3	657.7
Prior years(3)	**(54.7)**	(71.7)	(44.3)
Total	**590.8**	587.6	613.4
Loss and loss expense payments for claims occurring during:			
Current year	**368.7**	389.4	350.5
Prior years	**236.0**	248.5	242.8
Total	**604.7**	637.9	593.3
Impact of pooling change, January 1, 2005			35.3
End of Year:			
Net losses and loss expenses payable	**647.1**	661.0	711.3
Add: Reinsurance recoverable on losses and loss expenses payable(4)	**11.2**	13.5	17.4
Losses and loss expenses payable(5)	**$ 658.3**	674.5	728.7

(1) Includes amounts due from affiliates of $2.7 million, $5.5 million, and $5.7 million at beginning of year 2007, 2006, and 2005, respectively.

(2) Includes net amounts assumed from affiliates of $281.7 million, $302.6 million, and $296.9 million at beginning of year 2007, 2006, and 2005, 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 this Form 10-K Management s Discussion and Analysis section at 2007 Compared to 2006 Expenses and 2006 Compared to 2005 Expenses.

(4) Includes amounts due from affiliates of $1.2 million, $2.7 million, and $5.5 million at end of year 2007, 2006, and 2005, respectively.

(5) Includes net amounts assumed from affiliates of $257.2 million, $281.7 million, and $302.6 million at end of year 2007, 2006, and 2005, respectively.

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The following table sets forth our development of reserves for losses and loss expenses from 1997 through 2007. 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 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, 2007, we have paid 92.4% of the currently estimated losses and loss expenses that had been incurred, but not paid, as of December 31, 1997.

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 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 $28.0 million or 14.4% deficiency through December 31, 2007. This $28.0 million amount has been included in operating results over the ten years and did not have a significant effect on income in any one year.

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 2000, but incurred in 1997, 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 the MIGI Insurers. The amount of the assets transferred on the reserve liabilities assumed 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.

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($ millions)	Years Ended December 31										
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Net liability for losses and loss expenses payable	$ 194.2	$ 205.0	$ 221.7	$ 236.7	$ 509.9	$ 592.1	$ 628.8	$ 655.9	$ 711.3	$ 661.0	$ 647.1
Paid (cumulative) as of:											
One year later	32.7%	35.4%	41.8%	5.9%	43.4%	41.2%	36.7%	31.6%	34.9%	34.9%	
Two years later	54.6%	61.6%	43.0%	52.7%	65.3%	60.8%	53.2%	48.4%	51.1%		
Three years later	70.1%	62.1%	71.9%	79.9%	78.4%	71.4%	63.3%	59.6%			
Four years later	69.2%	78.8%	86.9%	95.5%	84.4%	77.3%	70.6%				
Five years later	77.1%	86.3%	96.1%	101.6%	88.5%	82.3%					
Six years later	81.8%	92.5%	99.0%	107.0%	92.3%						
Seven years later	85.8%	94.9%	102.4%	112.2%							
Eight years later	88.2%	97.4%	106.0%								
Nine years later	90.0%	100.3%									
Ten years later	92.4%										
Net liability re-estimate as of:											
One year later	93.0%	96.6%	97.5%	125.7%	102.4%	99.7%	96.5%	93.3%	89.9%	91.7%	
Two years later	92.0%	96.7%	119.1%	129.1%	105.1%	100.6%	93.2%	87.6%	86.4%		
Three years later	91.9%	111.9%	120.3%	133.1%	106.9%	98.8%	91.0%	86.9%			
Four years later	102.0%	111.5%	123.2%	136.1%	106.2%	98.5%	90.6%				
Five years later	101.4%	115.6%	126.7%	135.6%	107.1%	98.8%					
Six years later	106.1%	118.5%	127.9%	138.2%	107.7%						
Seven years later	108.9%	120.0%	128.9%	140.1%							
Eight years later	110.5%	121.5%	131.1%								
Nine years later	111.9%	123.9%									
Ten years later	114.4%										
Cumulative redundancy (deficiency)	$ (28.0)	$ (49.0)	$ (68.8)	$ (95.0)	$ (39.0)	$ 7.1	$ 59.1	$ 86.2	$ 96.9	$ 54.7	
Cumulative redundancy (deficiency)	(14.4)%	(23.9)%	(31.1)%	(40.1)%	(7.7)%	1.2%	9.4%	13.1%	13.6%	8.3%	
Gross* liability end of year	$ 402.7	$ 414.2	$ 438.7	$ 457.2	$ 743.7	$ 862.4	$ 934.0	$ 1,006.4	$ 1,111.1	$ 1,032.7	$ 1,029.9
Reinsurance recoverable	$ 208.5	$ 209.2	$ 217.0	$ 220.5	$ 233.8	$ 270.3	$ 305.2	$ 350.5	$ 399.8	$ 371.7	$ 382.8
Net liability end of year	$ 194.2	$ 205.0	$ 221.7	$ 236.7	$ 509.9	$ 592.1	$ 628.8	$ 655.9	$ 711.3	$ 661.0	$ 647.1
Gross liability re-estimated latest	107.7%	118.1%	119.4%	125.5%	107.5%	99.3%	93.1%	90.2%	89.0%	93.2%	
Reinsurance recoverable re-estimated latest	101.4%	112.5%	107.4%	109.9%	107.1%	100.4%	98.3%	96.4%	93.8%	95.8%	
Net liability re-estimated latest	114.4%	123.9%	131.1%	140.1%	107.7%	98.8%	90.6%	86.9%	86.4%	91.7%	

* 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										
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Reinsurance recoverable	$ 208.6	$ 209.2	$ 217.1	$ 220.5	$ 233.8	$ 270.3	$ 305.2	$ 350.5	$ 399.8	$ 371.7	$ 382.8

Amount netted against assumed from State Auto Mutual	$ 195.3	$ 197.7	$ 206.3	$ 212.6	$ 219.9	$ 261.5	$ 291.0	$ 324.6	$ 382.4	$ 358.2	$ 371.6
Net reinsurance recoverable	$ 13.3	$ 11.5	$ 10.8	$ 7.9	$ 13.9	$ 8.8	$ 14.2	$ 25.9	$ 17.4	$ 13.5	$ 11.2

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.

During 2007, the Beacon Group was added to the State Auto Group s reinsurance programs described below and as of January 1, 2008, the Patrons Group was added to these programs.

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 100% 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 the $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 and certain companies. 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. (Facultative reinsurance provides for a separate reinsurance agreement that is negotiated for a particular risk or insurance policy.)

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. The State Auto Group does not currently intend to renew the Catastrophe Assumption Agreement upon its expiration on July 1, 2008. The State Auto Group is considering

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other alternatives, such as securing replacement coverage from a third party reinsurer or relying upon the $100 million set aside under the Credit Agreement, discussed below, to fund this layer of catastrophe reinsurance, but currently no decision has been reached.

On July 12, 2007, State Auto Financial terminated its then-current credit agreement and entered into a new credit agreement (the Credit Agreement) with a syndicate of lenders which provides for a $200.0 million five-year unsecured revolving credit facility (the Credit Facility). During the term of the Credit Facility, we have the right to increase the total facility amount by $50.0 million, up to a maximum total facility amount of $250.0 million, provided that no event of default has occurred and is continuing. While the Credit Facility is available for general corporate purposes, including working capital, acquisitions and liquidity purposes, we presently intend to keep $100 million of the Credit Facility available in the event there is a need to fund losses under the catastrophe reinsurance program with State Auto P&C. 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.

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

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 insurance subsidiary within 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 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.

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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 at December 31, 2007, adjusted for dividend payments made in the previous twelve-month period, a total of $79.6 million is available in 2008 for payment as a dividend from our insurance subsidiaries to STFC without prior approval from our respective domiciliary state insurance departments. STFC received dividends of $50.0 million, $0.0, and $40.5 million in 2007, 2006, and 2005, 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 2007 which would materially impact our business.

In January 2007, the Florida legislature enacted new legislation which made fundamental changes to the property and casualty insurance business in Florida. This legislation was intended to address the cost of residential property insurance in Florida. After careful analysis of this legislation, we concluded that we could no longer operate our personal lines on a profitable basis in that state. Accordingly, during the second quarter 2007, we filed an application with the Florida Department of Insurance to withdraw from this state s personal lines insurance market effective January 1, 2008. Non-renewals on our personal lines business are in process. We will continue to write commercial lines business in Florida.

Many of the states in which we operate have passed or are considering legislation restricting or banning the use of credit scoring in the rating and risk selection process. In July 2007, the Federal Trade Commission (FTC) released a report on credit scoring and its impact on automobile insurance. The FTC concluded that credit-based scoring is an effective predictor of risk with respect to the issuance of automobile insurance policies to consumers, but has little effect as an indicator of racial or ethnic status of consumers. Despite the FTC s conclusions, some consumer groups and certain regulatory and legislative entities continue to resist the use of credit scoring in the rating and risk selection process. Banning or restricting this practice or data mining would limit our ability, and the ability of other carriers, to take advantage of the predictive value of this information. An FTC study reviewing the impact of credit scoring on homeowners insurance is pending. The homeowners insurance study could affect the future use of credit scoring based upon the findings of the FTC.

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, 2007, 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.

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The Terrorism Risk Insurance Act of 2002 and its successor, the Terrorism Risk Insurance Extension Act of 2005 (collectively, 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 the Terrorism Acts and that do not arise out of nuclear, biological or chemical agents. In December 2007, The United States Congress extended the Terrorism Acts through December 31, 2014. At the same time, Congress made modest changes to the Terrorism Acts for example, deleting the distinction between certified and non-certified (essentially foreign and domestic) acts of terrorism. Lines of business covered, as well as certain important coverage features (such as loss triggers, company deductibles and industry retentions) were not changed. We are evaluating these recent changes to the Terrorism Acts and are taking actions to comply. Our current property reinsurance treaties exclude certified acts of terrorism.

An area of regulatory focus in recent years and which may continue to receive additional attention in 2008 is producer compensation arrangements. Beginning in 2006, 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. 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 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.

Investments

Our investment portfolio is managed to provide growth of statutory surplus to facilitate increased premium writings over the long term while maintaining the ability to fund 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 its subsidiaries, although investment policies implemented by Stateco continue to be set for each company through the Investment Committee of its respective 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 maturity investments. We have investment policy guidelines with respect to purchasing fixed maturity investments for our insurance subsidiaries which preclude investments in bonds that are rated below investment grade by a recognized rating service. 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, 2007 and 2006, our bond portfolio had a fair value that totaled $1,745.4 million and $1,647.4 million, respectively.

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 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

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limit. Generally, investments in equity securities are selected based on their potential for appreciation as well as ability to continue paying dividends. See Item 7 of this Form 10-K, Management s Discussion and Analysis of Financial Condition and Results of Operations 2007 Compared to 2006 Investment Operations Segment Market Risks, for a discussion regarding the market risks related to our investment portfolio.

At December 31, 2007 and 2006, our equity portfolio was classified as available-for-sale and carried at fair value totaling $254.2 million and $284.2 million, respectively.

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

($ millions)	Year ended December 31		
	2007	2006	2005
Average Invested Assets(1)	**$ 1,987.1**	1,891.6	1,811.6
Net Investment Income(2)	**84.7**	83.1	78.7
Average Yield	**4.3%**	4.4%	4.3%

(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 and 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 this Form 10-K, Management s Discussion and Analysis of Financial Condition and Results of Operations Investment Operations Segment.

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 in Item 1A of this 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, 2008, we had 2,185 employees. Our employees are not covered by any collective bargaining agreement. We consider the relationship with our employees to be excellent.

Available Information

Our website address is www.stfc.com. Through this website (found by clicking the Investors link, then the All 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 100 F 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.

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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	57	Chairman of the Board and Chief Executive Officer of STFC and State Auto Mutual, 2/06 to present; President of STFC and State Auto 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.	2006
Mark A. Blackburn, Executive Vice President and Chief Operating Officer	56	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, 03/01 to 11/06.	1999
Steven E. English, Vice President and Chief Financial Officer	47	Vice President of STFC and State Auto Mutual, 05/06 to present; Chief Financial Officer of STFC and State Auto Mutual, 12/06 to present; Assistant Vice President of State Auto Mutual, 06/01 to 05/06.	2006
James E. Duemey, Vice President and Investment Officer	61	Vice President and Investment Officer of State Auto Mutual, 5/91 to present.	1991
Clyde H. Fitch, Jr. Senior Vice President and Chief Sales Officer	57	Senior Vice President and Chief Sales Officer of STFC and State Auto Mutual, 11/07 to present. Senior Vice President of Travelers Companies, Inc. for more than five years prior to 11/07.	2007
Steven R. Hazelbaker, Vice President and Director of Corporate Enterprise Risk Management	52	Vice President of State Auto Mutual and STFC, 6/01 to present.	2001
Cathy B. Miley, Vice President and Director of Corporate Development	58	Vice President of STFC, 3/98 to present; Vice President of State Auto Mutual, 3/95 to present.	1995
Cynthia A. Powell, Vice President and Treasurer	47	Treasurer of STFC and State Auto Mutual, 06/06 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	40	Vice President of STFC and State Auto Mutual, 11/06 to present; Vice President of Nationwide Insurance or its affiliates, 09/00 to 03/06, most recently serving as Vice President of Corporate HR of Nationwide Insurance.	2006

James A. Yano, Vice President, Secretary and General Counsel	56	Vice President, Secretary and General Counsel of STFC and State Auto Mutual 4/07 to present; Senior Vice President, Secretary and General Counsel of Abercrombie & Fitch Co. 5/05 to 3/07; Partner, law firm of Vorys, Sater, Seymour and Pease LLP for more than five years prior.	2007

(1) Age is as of March 5, 2008.
(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.

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Item 1A. Risk Factors

Statements contained in this Form 10-K may be forward-looking within the meaning of the Section 21E of the Exchange Act. 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 AND GEOGRAPHIC CONCENTRATIONS

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, 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. See Narrative Description of Business Regulation in Item 1 of this Form 10-K for a discussion regarding our recent personal lines action with respect to Florida. 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: 2007 with losses that occurred from hailstorms and windstorms in the Midwest resulting in approximately $10.8 million in pre-tax losses; 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.

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 AND PRICING

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 use of modeling tools to assist with correctly and consistently achieving the intended results in underwriting and pricing;
- our ability to innovate with new pricing strategies, and the success of those innovations on implementation;
- our ability to secure regulatory approval of premium rates on an adequate and timely basis;

our ability to predict policyholder retention accurately;

unanticipated court decisions, legislation or regulatory action;

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- 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.

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. While we may adjust prices during periods of intense competition, it remains our strategy to allow for 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

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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. Use of this distribution system may constrain our ability to grow at a comparable pace to our competitors that utilize multiple distribution channels. In addition, consumers may prefer to purchase insurance products through alternative channels, such as through the internet, rather than through agents.

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 86 years. However, we recognize that although the number of distribution locations has expanded, 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 an underwriting profit can have the effect of making top line growth more difficult. When price competition is intense, this effect is exaggerated by the fact 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 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.

In addition, consumers are increasingly using the internet and other alternative channels to purchase insurance products. While our website provides a significant amount of information about our insurance products, consumers cannot purchase insurance through our website. Instead, consumers must contact one of our independent agents in order to purchase any of our insurance products or make changes to their existing policies. This sole distribution system may place us at a disadvantage with consumers who prefer to purchase insurance products online or through other alternative distributions channels.

We also expect 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 could 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.

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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, underwriting limitations, transactions with affiliates, dividend limitations, (See Narrative Description of Business-Regulation-Dividends in Item 1), 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, in 2007, Florida enacted legislation that required us to charge rates for homeowners insurance that we believed were inadequate to cover the related underwriting risk. After careful analysis of this legislation, we concluded that we could no longer operate our personal lines on a profitable basis in that state. Accordingly, during the second quarter 2007, we filed an application with the Florida Department of Insurance to withdraw from this state s personal lines insurance market effective January 1, 2008. Non-renewals on our personal lines business are in process. We will continue to write commercial lines business in Florida.

Nearly all states require licensed insurers to participate in guaranty funds through assessments covering a portion of insurance claims against impaired or insolvent insurers. An increase in the magnitude of impaired companies could result in an increase in our share of such assessments. Residual market or pooling arrangements exist in many states to provide certain types of insurance coverage to those that are otherwise unable to find private insurers willing to insure them. Licensed insurers voluntarily writing such coverage are required to participate in these residual markets or pooling mechanisms. Such participation exposes the Company to possible assessments. The potential availability of recoupments or premium rate increases, if applicable, may not offset such assessments in the financial statements nor do so in the same fiscal periods.

Many of the states in which we operate have passed or are considering legislation restricting or banning 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.

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.

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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. An example would be a trend of plaintiffs targeting property and casualty insurers, including us, in purported class action litigation relating to claim-handling and other practices. 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. In December 2007, the United States Congress extended the Terrorism Acts through December 31, 2014, and made some modest changes to the Terrorism Acts. We are evaluating these changes to the Terrorism Act and are taking actions to comply. 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 6 to 24 months, we believe it is vitally important to our ability to maintain our prospects in business lines. Such automation was successfully put into production for businessowners products during the latter part of 2007. We expect to introduce such automation for commercial auto coverage during 2008, to be followed by development of this technology for workers compensation products. 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.

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 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. Individual securities in our fixed-income portfolio are subject to credit risk. Downgrades in the credit ratings of fixed maturities can have a significant negative effect of the market valuation of such securities.

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, our investments 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.

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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 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 or affiliated with other insurance companies, such as the MIGI Insurers, Milbank, Farmers, SA Wisconsin, and most recently the Beacon and Patrons Groups. It is anticipated that we and State Auto Mutual will continue to pursue acquisitions or affiliations of other insurance companies in the future.

Acquisitions and affiliations involve numerous risks and uncertainties, such as:

- obtaining necessary regulatory approvals may prove to be more difficult than anticipated;
- integrating the business may prove to be more costly than anticipated;
- integrating the 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 acquired or affiliated company or business may be worse than expected;

losses may develop differently than what we expected them to; and

retaining key employees of the acquired company or business may prove to be more difficult than anticipated.

In addition, other companies in the insurance industry have similar acquisition and affiliation strategies. Competition for target companies or businesses may intensify or we may not be able to complete such acquisitions or affiliations on terms and conditions acceptable to us. Additionally, the costs of unsuccessful acquisition and affiliation 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 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, 2007, our parent company owned approximately 64% 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.

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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.

The increased transparency that arises from information available from the use of tools such as comparative rater software, could work to our disadvantage. We may have difficulty differentiating our products or becoming among the lowest cost providers. Expense efficiencies are important to maintaining and increasing our growth and profitability. If we are unable to realize future expense efficiencies, it could affect our ability to establish competitive pricing and could have a negative effect on new business growth and retention of existing policyholders.

VOLATILITY OF OUR COMMON STOCK

The price of our common stock could be volatile.

The trading price of our common stock may fluctuate substantially due to a variety of factors, certain of which may not be related to our operating performance and are beyond our control. Such factors include, but are not limited to, the following: variations in our actual or anticipated operating results or changes in the expectations of financial market analysts; investor perceptions of our Company and/or the property and casualty industry; market conditions in the insurance industry and any significant volatility in the market; and major catastrophic events.

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.

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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 on the NASDAQ Global Select Market under the symbol STFC. As of February 21, 2008, there were 3,951 stockholders of record of our common shares.

Market Price Ranges and Dividends Declared on Common Shares

Initial Public Offering June 28, 1991 $2.25[1] 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:

2007	**High**	**Low**	**Dividend**
First Quarter	**$ 35.22**	**$ 30.61**	**$ 0.10**
Second Quarter	**34.00**	**28.67**	**0.10**
Third Quarter	**32.25**	**23.99**	**0.15**
Fourth Quarter	**32.38**	**25.39**	**0.15**

2006	High	Low	Dividend
First Quarter	$ 39.94	$ 30.59	$ 0.09
Second Quarter	36.33	31.11	0.09
Third Quarter	32.90	28.40	0.10
Fourth Quarter	35.15	29.25	0.10

(1) Adjusted for stock splits.

Additionally, see Item 7 of this 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 to State Auto Financial by its 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 2007:

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 of shares that may yet be purchased under the plans or programs

10/01/07	10/31/07	256,343	$ 27.62	256,343	3,650,657
11/01/07	11/30/07	388,175(2)	26.45	380,705	3,269,952
12/01/07	12/31/07	85,026(3)	27.27	83,482	3,186,470
Total		729,544	26.96	720,530	

(1) On August 17, 2007, State Auto Financial announced that its board of directors had authorized the repurchase, from time to time, of up to 4.0 million of its common shares, or approximately 10% of State Auto Financial s outstanding shares, over a period extending until

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December 31, 2009. State Auto Financial will repurchase shares from State Auto Mutual in amounts that are proportional to the respective current ownership percentages of State Auto Mutual, which is approximately 64%, and other shareholders.

(2) 7,470 shares acquired as a result of stock swap option exercises.

(3) 1,544 shares acquired as a result of stock swap option exercises.

Performance Graph

The line graph below compares the total return on $100 invested on December 31, 2002, 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.

	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006	**12/31/2007**
STFC	100.000	148.984	162.136	165.583	181.920	**197.280**
NASDAQ Index	100.000	122.725	149.000	166.399	188.819	**189.206**
NASDAQ Ins. Index	100.000	151.548	168.949	240.058	230.840	**178.389**

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Item 6. Selected Consolidated Financial Data

(dollars and shares in millions, except per share data)	Year ended December 31:				
	2007	2006	2005*	2004	2003
Statement of Income Data					
GAAP Basis:					
Earned premiums	**$ 1,011.6**	1,023.8	1,050.3	1,006.8	960.6
Net investment income	**$ 84.7**	83.1	78.7	71.8	64.6
Total revenues	**$ 1,113.4**	1,117.4	1,139.5	1,092.4	1,041.7
Net income	**$ 119.1**	120.4	125.9	110.0	63.6
Earned premium growth	**(1.2)%**	(2.5)	4.3	4.8	7.1
Return on average invested assets[(1)]	**4.3%**	4.4	4.3	4.5	4.6
Balance Sheet Data					
GAAP Basis:					
Total investments	**$ 2,021.2**	1,937.9	1,879.9	1,699.1	1,570.3
Total assets	**$ 2,337.9**	2,255.1	2,274.9	2,168.4	2,029.9
Total notes payable	**$ 118.0**	118.4	118.7	164.5	161.2
Total stockholders equity	**$ 935.5**	834.2	763.5	658.2	542.3
Common shares outstanding	**40.5**	41.0	40.5	40.1	39.6
Return on average equity[(2)]	**13.5%**	15.1	17.7	18.3	12.6
Debt to stockholders equity	**12.6%**	14.2	15.5	25.0	29.7
Per Common Share Data					
GAAP Basis:					
Basic EPS	**$ 2.90**	2.95	3.12	2.76	1.62
Diluted EPS	**$ 2.86**	2.90	3.06	2.70	1.58
Cash dividends per share	**$ 0.50**	0.38	0.27	0.17	0.15
Book value per share	**$ 23.10**	20.32	18.86	16.42	13.71
Common Share Price:					
High	**$ 35.22**	39.94	38.15	31.83	26.90
Low	**$ 23.99**	28.40	24.30	22.12	14.96
Close at December 31	**$ 26.30**	34.68	36.46	25.85	23.34
Close price to basic EPS	**9.07**	11.76	11.69	9.37	14.41
Close price to book value per share	**1.14**	1.71	1.93	1.57	1.70
GAAP Ratios:[(3)]					
Loss and LAE ratio	**58.4%**	57.4	58.4	61.5	67.8
Expense ratio	**34.4%**	34.0	31.7	30.2	30.4
Combined ratio	**92.8%**	91.4	90.1	91.7	98.2
Statutory Ratios:[(3)]					
Loss and LAE ratio	**57.9%**	56.8	58.4	61.6	67.9
Expense ratio	**33.2%**	32.9	31.6	30.6	30.7
Combined ratio	**91.1%**	89.7	90.0	92.2	98.6
Industry combined ratio[(4)]	**93.8%**	92.7	101.2	98.9	100.1
Net premiums written to surplus[(5)]	**1.1**	1.2	1.5	1.6	1.9

(1) Invested assets include investments and cash equivalents.

(2) Net income 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 2007 industry combined ratio is an estimate.

(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.

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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 markets a broad line of property and casualty insurance products through independent agencies in 33 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 64% of State Auto Financial s outstanding common shares.

State Auto P&C, Milbank, Farmers and SA Ohio (STFC Pooled Companies) participate in a quota share reinsurance pooling arrangement (the Pooling Arrangement) with State Auto Mutual, SA Florida, SA Wisconsin, Meridian Security and Meridian Citizens Mutual, which together with STFC Pooled Companies are referred to as the Pooled 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, which is not included in the Pooling Arrangement, provides nonstandard personal automobile insurance. Our Pooled Companies and SA National are rated A+ (Superior) by the A.M. Best Company.

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 2001. In general, the Pooling Arrangement covers all the property and casualty insurance written by the Pooled Companies except State Auto Mutual s voluntary assumed reinsurance, middle market business insurance written by State Auto Mutual and Meridian Security and intercompany catastrophe reinsurance written by State Auto P&C.

As of January 1, 2005, the Pooling Arrangement was modified to add Meridian Security and Meridian Citizens Mutual as participants. In conjunction with this modification, the STFC Pooled Companies received $54.0 million in cash from these two companies which related to the additional net insurance liabilities assumed on January 1, 2005.

As of January 1, 2008, the Pooling Arrangement was further modified to add Patrons Mutual, Litchfield and Beacon National as participants and to include the middle market business insurance written by State Auto Mutual and Meridian Security. Concurrently with the addition of Patrons Mutual, Litchfield and Beacon National, the participating percentages of certain participants were adjusted as presented in the table below; however the STFC Pooled Companies continue to maintain an overall share of the pool at 80% and State Auto Mutual and its subsidiaries and affiliates continue to maintain 20%. In conjunction with this modification, the STFC Pooled Companies will receive approximately $92.0 million in cash from State Auto Mutual and its subsidiaries and affiliates.

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The following table sets forth a chronology of the participant and participation percentages for the Pooling Arrangement since January 1, 2005:

	2005-2007(1)	2008(1)
STFC Pooled Companies:		
State Auto P&C	59.0%	59.0%
Milbank	17.0	17.0
Farmers	3.0	3.0
SA Ohio	1.0	1.0
Subtotal	80.0	80.0
Mutual Pooled Companies:		
State Auto Mutual	19.5	19.0
SA Wisconsin	0.0	0.0
SA Florida	0.0	0.0
Meridian Security	0.0	0.0
Meridian Citizens Mutual	0.5	0.5
Beacon National	N/A	0.0
Patrons Mutual	N/A	0.4
Litchfield	N/A	0.1
Subtotal	20.0	20.0

(1) Time period is for the year ended December 31, except for 2008, which is as of January 1, 2008.

The remainder of this discussion refers to the Pooling Arrangement in effect prior to January 1, 2008, unless otherwise noted.

Prior to January 1, 2007, we operated in two significant reportable segments, a standard segment and a nonstandard segment. In 2006, 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. We established integrated personal and business insurance teams with product, profit and production responsibilities for their respective areas. Consequently, beginning with first quarter 2007, our significant reportable segments are personal insurance, business insurance (collectively the insurance segments or our insurance segments) and investment operations, and we have begun reporting to our principal operating decision makers on these bases, analyzing each segment separately, to support our risk-based pricing focus.

We evaluate the performance of our insurance segments using industry financial measurements determined based on Statutory Accounting Principles (SAP), which include loss and loss adjustment expense ratios, underwriting expense ratios, combined ratios, statutory underwriting gain (loss), net premiums earned and net written premiums. One of the most significant differences between SAP and Generally Accepted Accounting Principles (GAAP) is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period the premium is earned. We evaluate our investment operations segment based on investment returns of assets. Financial information about our segments for 2007 is set forth in Note 15 to our Consolidated Financial Statements included in Item 8 of this Form 10-K. Prior period segment information has been restated to conform to current period presentation.

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 insure personal and small-to-medium business risks while adhering to disciplined and consistent underwriting principles through all market cycles.

Our underwriting 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 an underwriting profit 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 agents by stressing the strengths we bring to the marketplace. These strengths include stability, financial soundness, prompt and fair claims service, and technology which make it easier for the agent to do business with the State Auto Group and provide substantial value to our customers. We carefully monitor writing insurance in states that we believe present difficult legislative, judicial and/or regulatory environments for the insurance industry.

Investment Strategy: We have a disciplined approach to our investment strategy that emphasizes the quality of our fixed maturity portfolio, which comprised 86% of our total portfolio at fair value at December 31, 2007, and includes only investment grade securities. During the last year our strategy has included increasing our positions in tax-exempt fixed maturities in an effort to maximize after tax investment income in conjunction with diversifying into additional asset classes, such as treasury inflation protected securities. Our only investments in asset-backed securities are in federal agency pools and government guaranteed GNMAs. Our internally managed equity portfolio, which comprised approximately 13% at fair value of our total portfolio at December 31, 2007, emphasizes large-cap, dividend-paying companies selected based upon their potential for appreciation as well as ability to continue paying dividends. During the fourth quarter, 2007, we began to diversify our equity portfolio, and utilize outside managers to invest in U.S. small-cap equities and international instruments. By diversifying, we hope to achieve a greater total return with reduced volatility.

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.

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

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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 33 states as of January 1, 2008. As we begin 2008, the concentration of our direct 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 approximately 17% at January 1, 2008. Our underwriting guidelines are designed to limit exposures to 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). In 2007, we established claims catastrophe teams to enhance our response to policyholders in catastrophe loss situations.

Independent Insurance Agent Network: We offer our products through over 3,000 agencies in 33 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, 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, contingent commissions, 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 our agents grow their book of business with us profitably and, thus, enhance the long-term value of our relationship. Our senior management meets frequently with agents to encourage mutual growth and demonstrate our 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 technology efforts are focused on making us as efficient and effective as possible. In 2007, our personal insurance segment technology leveraged past successes with our netXpress agency portal by putting emphasis on the integration between various third party technologies and netXpress. One such example was adding functionality to bridge data directly into our netXpress portal from comparative rating tools thus eliminating the re-keying effort and increasing the data quality level. Agency personnel have welcomed this functionality and rewarded us with increased quote opportunities and submissions. It has also positioned us to be more effective on book rollover opportunities. Other integration examples include agency management systems and services that dynamically order underwriting products like motor vehicle reports, credit reports, and geographic data used in our pricing algorithms.

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Our business insurance segment benefited by the introduction of our bizXpress^{SM} portal. The bizXpress^{SM} portal was deployed in all of our states of operation (except Florida) in 2007. During the course of 2007, several disciplines were more effectively used in our technology efforts. Quality assurance practices were formalized and used resulting in less defects in applications once deployed. Additionally, more project management rigor and application governance allowed our project delivery to be more predictable for all business segments. Finally, we implemented performance testing tools and application monitoring technologies so we can increase our responsiveness and operate our information systems infrastructure efficiently.

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 in this Item 7. 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

Our fixed maturity, equity security and certain other invested asset 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 we consider are the nature of the investment, severity and length of decline in fair value, events impacting the issuer, overall market conditions and our intent and ability to hold securities until 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 2007 Compared to 2006 and 2006 Compared to 2005 included in this Item 7.

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, 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.

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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 we use many internal and external resources, as well as multiple established methodologies to calculate IBNR, there is no method for determining the exact ultimate liability. For a further discussion regarding our losses and loss expense reserves and our reserving methods see Other Loss and Loss Expense Reserves included in this Item 7.

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. We review these factors annually, including the discount rate and expected long term rate of return on plan assets. Because these obligations are based on 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 in this Item 7.

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.

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.

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RESULTS OF OPERATIONS

Summary

The following table summarizes certain key performance indicators used to manage our operations for the years ended December 31, 2007, 2006 and 2005, respectively:

($ millions, except per share data)	**2007**	2006	2005
GAAP Basis:			
Total revenues	**$ 1,113.4**	1,117.4	1,139.5
Net income	**$ 119.1**	120.4	125.9
Stockholders equity[1]	**$ 935.5**	834.2	763.5
Book value per share[1]	**$ 23.10**	20.32	18.86
Loss and LAE ratio[2]	**58.4**	57.4	58.4
Expense ratio[2]	**34.4**	34.0	31.7
Combined ratio	**92.8**	91.4	90.1
Catastrophe loss and LAE points[2]	**3.7%**	8.9	6.9
Premium written growth[3]	**0.0%**	(2.5)	5.0
Premium earned growth	**(1.2)%**	(2.5)	4.3
Investment yield	**4.3%**	4.4	4.3
SAP Basis:			
Loss and LAE ratio[4]	**57.9**	56.8	58.4
Expense ratio[4]	**33.2**	32.9	31.6
Combined ratio[4]	**91.1**	89.7	90.0
Net premiums written to surplus[5]	**1.1**	1.2	1.5

(1) At December 31, 2006, accumulated comprehensive income was reduced by $63.9 million and book value per share was reduced by $1.56, respectively, in connection with the initial 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 in this Item 7.

(2) See 2007 Compared to 2006 section below for definitions.

(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 Meridian Security and Meridian Citizens Mutual to the Pooling Arrangement.

(4) SAP loss and LAE ratio is statutory losses and loss expenses as a percentage of net earned premium. SAP expense ratio is statutory underwriting expenses and miscellaneous expenses offset by miscellaneous income (underwriting expenses) as a percentage of net written premiums. SAP combined ratio is the sum of the SAP loss and LAE ratio and the SAP expense ratio.

(5) 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.

2007 Compared to 2006

Income before federal income tax decreased $6.4 million (4.0%) to $155.3 million from 2006. The most significant factors contributing to this decrease related to a decline in our revenues, specifically our premiums, and an increase in our loss and loss expenses. Our GAAP loss and loss expense ratio for 2007 was 58.4% compared to 57.4% in 2006.

Insurance Segments

Insurance industry regulators require our insurance subsidiaries to report their financial condition and results of operations using SAP. We use SAP financial results, along with industry standard financial measures determined on a SAP basis and certain measures determined on a GAAP basis, to internally monitor the performance of our insurance segments and reward our employees. The more common financial measures used are loss and LAE ratio, underwriting expense ratio, combined ratio, net premiums written and net premiums earned. The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio. When the

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combined ratio is less than 100%, the insurer is operating at an underwriting gain and when it is greater than 100%, the insurer is operating at an underwriting loss. Underwriting gain (loss) is determined by subtracting from net earned premiums, losses and loss expenses and underwriting expenses.

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred policy acquisition costs see Critical Accounting Policies Deferred Acquisition Costs included in this Form 10-K. 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). All references to financial measures or components thereof in this discussion are calculated on a GAAP basis, unless otherwise noted.

The following tables provide a summary of our insurance segments SAP underwriting gain and SAP combined ratio for the years ended December 31, 2007 and 2006:

($ millions)	**2007**					
	Personal	**% Ratio**	**Business**	**% Ratio**	**Total**	**% Ratio**
Written premiums	**$ 615.1**		**$ 404.7**		**$ 1,019.8**	
Earned premiums	**609.6**		**402.0**		**1,011.6**	
Losses and loss expenses	**378.4**	**62.1**	**207.2**	**51.5**	**585.6**	**57.9**
Underwriting expenses	**183.9**	**29.9**	**154.2**	**38.1**	**338.1**	**33.2**
SAP underwriting profit and SAP combined ratio	**$ 47.3**	**92.0**	**$ 40.6**	**89.6**	**$ 87.9**	**91.1**

($ millions)	2006					
	Personal	% Ratio	Business	% Ratio	Total	% Ratio
Written premiums	$ 612.8		$ 406.7		$ 1,019.5	
Earned premiums	614.8		409.0		1,023.8	
Losses and loss expenses	389.6	63.4	192.4	47.0	582.0	56.8
Underwriting expenses	180.4	29.4	155.1	38.1	335.5	32.9
SAP underwriting profit and SAP combined ratio	$ 44.8	92.8	$ 61.5	85.1	$ 106.3	89.7

Revenue

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

Personal Insurance Segment Revenue

Our personal insurance segment consists primarily of auto (standard and nonstandard) and homeowners products, with personal auto representing approximately 40% of our total consolidated net written premium in

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2007 and 2006. The following table provides a summary of written and earned premium, net of reinsurance, by major product line of business for our personal insurance segment for the years ended December 31, 2007 and 2006:

($ millions)	**2007**	2006	% Change
Personal Insurance Segment:			
Net Written Premium			
Standard auto	**$ 361.5**	361.7	(0.1)
Nonstandard auto	**42.7**	42.4	0.7
Homeowners	**187.7**	186.1	0.9
Other personal	**23.2**	22.6	2.7
Total personal	**$ 615.1**	612.8	0.4
Net Earned Premium			
Standard auto	**$ 357.3**	362.1	(1.3)
Nonstandard auto	**42.9**	44.8	(4.2)
Homeowners	**186.5**	185.2	0.7
Other personal	**22.9**	22.7	0.9
Total personal	**$ 609.6**	614.8	(0.8)

In total, the personal insurance segment net written premium increased from 2006 by 0.4%. While a modest increase, it does represent an improvement from 2006 which declined approximately 3.5% from 2005. In particular, competition remains intense within the personal auto market, which is contributing to our overall modest growth. It remains our strategy that rates be risk-based, reflecting the underlying loss and expense trends.

Net written premiums for our standard auto products decreased 0.1% in 2007 compared to 2006. The competitive marketplace combined with some rate reductions in 2007 contributed to this result. However, we have seen increasing new business production related to the introduction of our CustomFit^{SM} product into new states. CustomFit^{SM} uses a multi-variate rating approach that broadens the underwriting eligibility for new customers. In 2007, we began introducing the second generation of CustomFit^{SM}, which further improves our rating sophistication.

Net written premiums for nonstandard personal auto increased 0.7% in 2007 compared 2006. This represents a significant improvement compared to the 2006 premium result which declined 13.3% from 2005. Targeted rate decreases coupled with the introduction of new discounts and an increased marketing effort contributed to an increased level of new policy submissions leading to an increase in premiums.

We believe independent agents value ease of doing business and make it an important factor in their choice of insurance companies when quoting personal auto products to their customers. During 2007, we introduced in 17 states various real time comparative rating tools which can be used by our independent agents to prepare comparative rate quotes from multiple insurance companies by entering the rating information once. We believe our independent agents will quote and write more personal standard and nonstandard auto with us as a result of a more efficient quoting process.

Homeowners net written premium increased 0.9% in 2007 compared to 2006. In 2007, we introduced a home purchase discount and expanded our age of dwelling discounts to help attract new business which we believe contributed favorably to increased new homeowners policy submission levels.

During 2007, we continued to enhance our personal lines point of sale portal, netXpress, by adding several new integration options with a variety of third party tools used by our independent agents including a

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joint credit ordering tool, integrated report ordering, and the comparative rating tools mentioned above. We also have added a number of internal integration points through the use of web services technology. One example of this is real time integration with our enterprise billing system to provide accurate installment information via netXpress™ . The goal of these technology investments is to streamline quoting and policy issuance for our agents. We strive to be their carrier of choice and ease of doing business is a major driver toward that goal.

We have also focused on improving our policyholders ease of doing business with respect to bill payment and claim reporting and settlement. In 2006, we expanded our premium payment options to include credit and debit card via www.stateauto.com. In 2007, we deployed an Interactive Voice Response (IVR) solution to accept premium payments over the phone providing yet another option for policyholders. The IVR solution provides a more efficient business process for our payment services department and is expected to drive better policy retention results. During 2007, nearly 189,000 payments were made through self-service technologies such as these representing over $76 million of premium payments.

Additionally, we recently completed several strategic initiatives to enhance our claims handling ability and better manage major catastrophes. Field claims personnel are now equipped with mobile devices that permit adjusting property claims at the loss site. We believe that our professional claims service backed by reliable technology will continue to distinguish us from our competitors.

During the second quarter 2007, we filed an application with the Florida Department of Insurance to withdraw from the state s personal lines insurance market effective January 1, 2008. After a careful analysis of recent regulatory changes in Florida, we concluded that we could no longer operate our personal lines on a profitable basis in that state. Non-renewals on this business are in process. We will continue to write commercial lines business in Florida. During 2007, we wrote $12.5 million of personal lines premium in Florida.

Business Insurance Segment Revenue

We focus our business insurance sales on small to medium sized exposures and offer a broad range of both property and liability coverages such as commercial auto, commercial multi-peril, fire and allied lines, products liability and workers compensation. The following table provides a summary of written and earned premium, net of reinsurance, by major product line of business for our business insurance segment for the years ended December 31, 2007 and 2006:

($ millions)	**2007**	2006	% Change
Business Insurance Segment:			
Net Written Premium			
Commercial auto	**$ 95.8**	98.7	(2.9)
Commercial multi-peril	**86.6**	87.8	(1.4)
Fire & allied lines	**84.0**	83.1	1.1
Other & product liability	**75.6**	77.2	(2.1)
Workers compensation	**36.1**	34.3	5.2
Other commercial	**26.6**	25.6	3.9
Total business	**$ 404.7**	406.7	(0.5)
Net Earned Premium			
Commercial auto	**$ 96.9**	100.3	(3.4)
Commercial multi-peril	**86.8**	87.5	(0.8)
Fire & allied lines	**83.4**	84.2	(1.0)
Other & product liability	**75.5**	77.5	(2.6)
Workers compensation	**33.4**	33.8	(1.2)
Other commercial	**26.0**	25.7	1.2
Total business	**$ 402.0**	409.0	(1.7)

The business insurance segment net written premium for 2007 decreased 0.5% from 2006. Business insurance continues to be impacted by rate competition and ease of doing business issues. We are seeking to balance our traditional underwriting discipline with new products and pricing tools that support the production of profitable new business.

In 2007, we began offering our business products in two new states Colorado and Texas and increased the number of business products offered in Arizona.

We also continue to enhance our back office systems which enable us to more effectively support our independent agents. We recently implemented the technology to provide real time functionality in our business insurance policy administration systems for quote and issuance transactions. Also known as straight through processing (STP), our associates are now able to more effectively and accurately handle typical business insurance processing. The policy service time has been greatly reduced as a result of this new technology.

To make it easier for our agents to submit business insurance accounts, in 2007, we introduced bizXpress^{SM}, our web-based quote and issuance system, to agents in all of our operating states except Florida. We currently utilize bizXpress^{SM} for businessowners policies. We are working to expand bizXpress^{SM} functionality to our business auto products in the first half of 2008, while we develop the same functionality for workers compensation business for introduction at a later date. This has been a highly collaborative initiative that has included agent focus group input throughout the project lifecycle. It also leverages the STP technology investment mentioned above. We believe this technology investment should better position us for revenue growth opportunities in the future and start to drive efficiencies into our business model much like we have seen in personal insurance.

Losses and Expenses

Our GAAP loss and LAE ratio was 58.4% in 2007 compared to 57.4% in 2006. Loss results for the year have been mixed. Our core auto (personal and business) and other and product liability lines continue to perform well. On the property side, catastrophe losses for 2007 were lower than in 2006, but we experienced significantly higher frequency of large fire losses within our personal and business lines during 2007.

Losses and loss expenses for a calendar year represent the combined estimated ultimate liability for claims occurring in the current calendar year along with development of claims occurring in prior years. The following table presents the provision for losses and loss expenses for those claims occurring in the current calendar year and prior years, along with the GAAP loss and LAE ratio for the years 2007 and 2006, respectively:

($ millions)	**2007**	**% GAAP loss and LAE**	2006	% GAAP loss and LAE
Provision for losses and loss expenses occurring:				
Current year	**$ 645.5**	**62.7**	659.3	64.4
Prior years	**(54.7)**	**(4.3)**	(71.7)	(7.0)
Total losses and loss expenses	**$ 590.8**	**58.4**	587.6	57.4

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A tabular presentation of the 2007 $54.7 million favorable development broken down by accident year is shown below.

($ millions)

Accident year		Current year development of ultimate liability *Redundancy /(Deficiency)*
1997 and prior	$	(4.8)
1998		(0.1)
1999		0.2
2000		0.2
2001		1.8
2002		1.1
2003		4.3
2004		2.3
2005		20.2
2006		29.5
Total	$	54.7

Normal fluctuations and uncertainty associated with loss reserve development and claim settlement contributed to favorable development in the respective calendar years. The favorable development of $54.7 million in 2007 came primarily from accident years 2005-2006. The more notable items contributing to the 2007 development are:

Favorable development at the product level is primarily from the auto liability and other liability lines, where current loss projections using more mature claim data resulted in lower expected average claim severities than past projections. The impact is approximately $23.5 million for these two lines combined.

Adjusting and other expense reserves accounted for approximately $11.8 million of prior year reserve change. These expense reserves have a proportional relationship to the overall claim inventory and held reserves by accident year, as they move up or down in relation to carried loss reserves. Since reserves decreased for the prior accident years, the expense reserves declined in a similar fashion. (Allocated loss adjustment expenses (ALAE) are those costs that can be related to a specific claim, which may include attorney fees, external claims adjusters and investigation costs, among others. Unallocated loss adjustment expenses (ULAE) are those costs incurred in settling claims, such as in-house processing costs, for which no identification can be made to specific claims. Adjusting and other expenses are the components of ALAE and ULAE that relate to costs other than defense, litigation, and medical cost containment.)

We hold ceded loss reserves in anticipation of transferring liabilities to reinsurers and other pools and associations. Ceded loss reserves were above previously anticipated levels by approximately $10.0 million. Historically, we have had less ceded loss activity because our reinsurance retention levels are generally high enough to exclude most claims. This favorable development occurred primarily in the fire, auto liability and workers compensation lines.

Favorable catastrophe loss development of approximately $4.6 million is attributable to the 2006 accident year. This development occurred primarily within our homeowners, other personal and commercial multi-peril lines of business.

The remaining favorable development is spread across several lines of business and is generally the result of having fewer claims emerge and lower claim severity than anticipated in the estimates developed as of December 31, 2006.

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See discussion regarding the 2006 calendar year development at 2006 Compared to 2005 Losses and Expenses section included herein. See additional discussion regarding loss and loss expense reserves at the Other Loss and Loss Expense Reserves section included herein.

Catastrophe losses in 2007 totaled $37.1 million (3.7 loss ratio points) compared to $91.2 million (8.9 loss ratio points) in 2006. During 2007, our catastrophe losses resulted primarily from wind and hail in several Midwestern states and mostly impacted our homeowners business. Catastrophe activity in 2006 had a significant impact on both our personal and business insurance property lines. The discussion of catastrophe losses includes those which have been designated as such by ISO s Property Claim Services (PCS) unit, a nationally recognized industry service. PCS defines catastrophes as events resulting in $25.0 million or more in insured losses industry wide and affecting significant numbers of insureds and insurers.

The following table provides our insurance segments comparative SAP loss and LAE ratios (loss ratios) by major line of business for 2007 and 2006:

	2007	2006	Improve (Deteriorate)
Personal insurance segment:			
Standard auto	**61.5**	57.0	(4.5)
Nonstandard auto	**63.2**	60.0	(3.2)
Homeowners	**64.6**	78.1	13.5
Other personal	**48.2**	51.1	2.9
Total personal	**62.1**	63.4	1.3
Business insurance segment:			
Commercial auto	**52.2**	40.3	(11.9)
Commercial multi-peril	**59.3**	48.6	(10.7)
Fire & allied lines	**49.1**	58.3	9.2
Other & product liability	**43.5**	37.5	(6.0)
Workers compensation	**74.6**	57.5	(17.1)
Other commercial	**24.8**	46.3	21.5
Total business	**51.5**	47.0	(4.5)
Total SAP personal and business	**57.9**	56.8	(1.1)

The personal insurance segment loss ratio was 1.3 points lower in 2007 than in 2006. Catastrophes accounted for 5.0 loss ratio points in 2007 compared to 11.9 points in 2006 period. Excluding the impact of catastrophes, the personal lines loss ratio in 2007 was 5.5 points higher than in 2006 period. The increase in both the standard and nonstandard auto loss ratios can be attributed partially to rate reductions taken in 2006 and 2007. The improvement in the homeowners loss ratio can be attributed primarily to the reduction of catastrophe losses. In 2007, catastrophes added 14.2 points to the homeowners loss ratio compared to 32.2 points in 2006 period.

The business insurance segment s loss ratio for 2007 was 4.5 points higher than in 2006. Catastrophes accounted for 1.6 loss ratio points in 2007 compared to 4.3 points in 2006. Excluding the impact of catastrophes, the business lines loss ratio in 2007 was 7.2 points higher than in 2006. The overall increase reflects rate reductions in premium per exposure on business written in 2006 and 2007 and an increase in the number of large property losses. Workers compensation, which represents approximately 9.0% of our business insurance portfolio and less than 4.0% of our overall insurance segment portfolio, tends to be a more volatile line of business due to its size and risks written. We do not write mono-line workers compensation, but make our product available as part of the business package policy. The increase in the level of 2007 losses as compared to 2006 was driven largely by an increase in severity rather than frequency. We regularly monitor frequency and severity trends, as well as the overall construction of our workers compensation book of business. In addition, we promote the writing of the low-hazard risk types that have developed a consistent pattern of profitability.

Acquisition and operating expenses, as a percentage of earned premiums (GAAP expense ratio) were 34.4% in 2007 compared to 34.0% in 2006. The 2007 expense ratio was largely impacted by a lower premium base in 2007 compared to 2006.

Investment Operations Segment

Our investment portfolio and the investment portfolios of State Auto Mutual, and its subsidiaries and affiliates are managed by our subsidiary, Stateco. The Investment Committee of the Board of Directors of each of our insurers sets investment policies to be followed by Stateco.

At December 31, 2007, our investments in fixed maturities, equity securities and certain other invested assets were held as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are included as a separate component of stockholders equity as accumulated other comprehensive loss and as such are not included in the determination of net income.

Our primary investment objectives are to generate income, preserve capital and maintain adequate liquidity for the payment of claims and expenses. Our current investment strategy does not rely on the use of derivative financial instruments.

We have investment policy guidelines with respect to purchasing fixed maturity investments for our insurance subsidiaries which preclude investments in bonds that are rated below investment grade by a recognized rating service. For the insurance subsidiaries, the maximum investment in any single note or bond is limited to 5.0% or less of statutory assets, other than obligations of the U.S. government or government agencies, for which there is no limit. Our fixed maturity portfolio is composed of high quality, investment grade issues, comprised almost entirely of debt issues rated AAA or AA. At December 31, 2007, we had no fixed maturity investments rated below investment grade. Our only investments in asset-backed securities are in federal agency pools and government guaranteed GNMAs.

Our internally managed equity portfolio invests in U.S. large-cap, dividend-paying companies across many different industries selected based upon their potential for appreciation as well as ability to continue paying dividends. This diversification across companies and industries reduces volatility in the value of the large-cap equity portfolio. In addition, our investment policy guidelines limit the purchase of a specific stock to no more than 2% of the market value of the stock at the time of purchase, and no single equity holding should exceed 5% of the total equity portfolio.

During the fourth quarter 2007, we began to diversify our equity portfolio and utilize outside money managers to invest in U.S. small-cap equities and international instruments. These managers are permitted to manage the portfolios according to their own respective portfolio objectives. In selecting our outside money managers we confirm that their portfolio objectives, including risk tolerance, are acceptable to us; however, there may be slight differences in their objectives with respect to dividend payments and other constraints that we apply to our large cap equity holdings. By further diversifying our portfolio into small-cap equities and international instruments, we hope to achieve a greater total return with reduced volatility.

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In August 2007, we completed a portfolio diversification study with the objective to reduce the volatility of the returns and improve our overall after-tax return while continuing to maintain a high-quality portfolio. Based on this study, the Committee (defined below) approved the following target asset allocation:

Cash and cash equivalents	**3.5%**
Core fixed maturities	**69.0**
Treasury inflation protected securities	**10.0**
Large-cap equities	**10.5**
Small-cap equities	**3.0**
International instruments	**4.0**
Total portfolio	**100.0%**

Composition of Investment Portfolio

Beginning in the fourth quarter of 2007, we began investing funds as they became available moving toward our targeted asset allocations over the next 12 to 18 months. The following table provides a breakdown of our investments relative to our targeted allocated percentages provided above at December 31, 2007. We measure our investment portfolio allocation with fixed maturities at amortized cost and equities and international instruments at fair value.

($ millions)		**% of Total**
Cash and cash equivalents	**$ 70.9**	**3.4**
Core fixed maturities	**1,710.0**	**82.6**
Treasury inflation protected securities	**12.9**	**0.6**
Large-cap equities	**242.7**	**11.7**
Small-cap equities	**11.5**	**0.6**
International instruments	**15.9**	**0.8**
Other invested assets	**5.7**	**0.3**
Total portfolio	**$ 2,069.6**	**100.0**

The following table provides the composition of our available-for-sale investment portfolio at December 31, 2007 and 2006, respectively:

($ millions)	**2007**		2006	
Fixed maturities	**$ 1,745.4**	**86.4%**	1,647.4	85.1
Equity securities	**254.2**	**12.6**	284.2	14.7
Other invested assets	**20.3**	**1.0**	4.5	0.2
Total investments, at fair value	**$ 2,019.9**	**100.0%**	1,936.1	100.0

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The amortized cost and fair value of fixed maturities at December 31, 2007, by contractual maturity, are as follows:

($ millions)	Amortized Cost	Fair Value
Due in 1 year or less	$ 16.9	16.9
Due after 1 year through 5 years	60.5	62.5
Due after 5 years through 10 years	437.5	451.1
Due after 10 years	1,019.4	1,025.4
U.S. government agencies mortgage-backed securities	188.6	189.5
Total	$ 1,722.9	1,745.4

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

At December 31, 2007, our equity portfolio consisted of approximately 80 different large-cap stocks and 325 small-cap stocks. The largest single position was 3.2% of the equity portfolio based on fair value and the top ten positions were equal to approximately 25.1% of the equity portfolio.

Our equity portfolio consists primarily of large-cap, value-oriented stocks with a small allocation to small-cap equities. Therefore, when large-cap stocks and/or value-oriented stocks perform well our equity portfolio typically performs well compared to benchmarks. Conversely, when growth stocks outperform value and/or small- to mid-cap stocks outperform large-cap stocks, our equity portfolio does not perform as well compared to benchmarks. This is due to the significant overweighting in large-cap, value-oriented stocks versus small-cap and growth stocks in the portfolio.

The chart below shows the industry sector breakdown of our large-cap equity portfolio versus the S&P 500 Index based on fair value as of December 31, 2007.

	Equity Portfolio	S&P 500 Index
Industry Sector	**% of Fair Value**	**% of Fair&nb**