

PRINCIPAL FINANCIAL GROUP INC

Form 10-Q

May 04, 2011

Table of Contents

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

---

- x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended March 31, 2011**

**OR**

- o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**
- 

**1-16725**

**(Commission file number)**

**PRINCIPAL FINANCIAL GROUP, INC.**

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**42-1520346**

(I.R.S. Employer Identification Number)

**711 High Street, Des Moines, Iowa 50392**

(Address of principal executive offices)

**(515) 247-5111**

(Registrant's telephone number, including area code)

---

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

The total number of shares of the registrant's Common Stock, \$0.01 par value, outstanding as of April 27, 2011, was 321,318,850.



Table of Contents

PRINCIPAL FINANCIAL GROUP, INC.

TABLE OF CONTENTS

	<b>Page</b>
<u>Part I - FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	
<u>Financial Statements</u>	3
<u>Consolidated Statements of Financial Position at March 31, 2011 (Unaudited) and December 31, 2010</u>	3
<u>Unaudited Consolidated Statements of Operations for the three months ended March 31, 2011 and 2010</u>	4
<u>Unaudited Consolidated Statements of Stockholders' Equity for the three months ended March 31, 2011 and 2010</u>	5
<u>Unaudited Consolidated Statements of Cash Flows for the three months ended March 31, 2011 and 2010</u>	6
<u>Notes to Unaudited Consolidated Financial Statements - March 31, 2011</u>	8
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	71
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	106
<u>Item 4.</u>	
<u>Controls and Procedures</u>	112
<u>Part II - OTHER INFORMATION</u>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	112
<u>Item 1A.</u>	
<u>Risk Factors</u>	112
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	113
<u>Item 6.</u>	
<u>Exhibits</u>	114
<u>Signature</u>	115

---

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****Principal Financial Group, Inc.****Consolidated Statements of Financial Position**

	March 31, 2011 (Unaudited)	December 31, 2010
	(in millions)	
<b>Assets</b>		
Fixed maturities, available-for-sale (2011 and 2010 include \$262.9 million and \$257.9 million related to consolidated variable interest entities)	\$ 48,305.5	\$ 48,636.3
Fixed maturities, trading (2011 and 2010 include \$135.0 million and \$131.4 million related to consolidated variable interest entities)	1,006.3	1,120.3
Equity securities, available-for-sale	175.8	169.9
Equity securities, trading (2011 and 2010 include \$218.6 million and \$158.6 million related to consolidated variable interest entities)	389.7	316.9
Mortgage loans	10,900.0	11,125.1
Real estate	1,010.0	1,063.5
Policy loans	893.0	903.9
Other investments (2011 and 2010 include \$122.5 million and \$128.7 million related to consolidated variable interest entities, of which \$122.2 million and \$128.3 million are measured at fair value under the fair value option)	2,676.4	2,641.6
Total investments	65,356.7	65,977.5
Cash and cash equivalents (2011 and 2010 include \$113.7 million and \$100.0 million related to consolidated variable interest entities)	1,984.2	1,877.4
Accrued investment income	675.6	666.1
Premiums due and other receivables	1,309.9	1,063.0
Deferred policy acquisition costs	3,549.9	3,529.8
Property and equipment	448.7	458.7
Goodwill	344.5	345.4
Other intangibles	829.3	834.6
Separate account assets	71,724.5	69,555.3
Other assets	1,326.4	1,323.3
Total assets	\$ 147,549.7	\$ 145,631.1
<b>Liabilities</b>		
Contractholder funds	\$ 36,609.3	\$ 37,301.1
Future policy benefits and claims	19,975.3	20,046.3
Other policyholder funds	607.5	592.2
Short-term debt	106.8	107.9
Long-term debt	1,579.8	1,583.7
Income taxes currently payable	3.6	6.2
Deferred income taxes	542.7	409.9
Separate account liabilities	71,724.5	69,555.3
Other liabilities (2011 and 2010 include \$517.7 million and \$433.6 million related to consolidated variable interest entities, of which \$106.4 million and \$114.5 million are	6,027.4	6,143.5

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

measured at fair value under the fair value option)

Total liabilities	<b>137,176.9</b>	135,746.1
<b>Stockholders' equity</b>		
Series A preferred stock, par value \$.01 per share with liquidation preference of \$100 per share 3.0 million shares authorized, issued and outstanding in 2011 and 2010		
Series B preferred stock, par value \$.01 per share with liquidation preference of \$25 per share 10.0 million shares authorized, issued and outstanding in 2011 and 2010	<b>0.1</b>	0.1
Common stock, par value \$.01 per share 2,500.0 million shares authorized, 449.6 million and 448.5 million shares issued, and 321.3 million and 320.4 million shares outstanding in 2011 and 2010	<b>4.5</b>	4.5
Additional paid-in capital	<b>9,580.1</b>	9,563.8
Retained earnings	<b>4,808.6</b>	4,612.3
Accumulated other comprehensive income	<b>525.5</b>	272.4
Treasury stock, at cost (128.3 million and 128.1 million shares in 2011 and 2010)	<b>(4,731.2)</b>	(4,725.3)
Total stockholders' equity attributable to Principal Financial Group, Inc.	<b>10,187.6</b>	9,727.8
Noncontrolling interest	<b>185.2</b>	157.2
Total stockholders' equity	<b>10,372.8</b>	9,885.0
Total liabilities and stockholders' equity	<b>\$ 147,549.7</b>	\$ 145,631.1

See accompanying notes.

Table of Contents

**Principal Financial Group, Inc.**  
**Consolidated Statements of Operations**  
**(Unaudited)**

	For the three months ended	
	March 31,	
	2011	2010
	(in millions, except per share data)	
<b>Revenues</b>		
Premiums and other considerations	\$ 797.1	\$ 878.9
Fees and other revenues	620.8	567.6
Net investment income	859.9	863.0
Net realized capital gains (losses), excluding impairment losses on available-for-sale securities	(5.6)	33.7
Total other-than-temporary impairment losses on available-for-sale securities	(14.0)	(84.6)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income	(38.4)	5.4
Net impairment losses on available-for-sale securities	(52.4)	(79.2)
Net realized capital losses	(58.0)	(45.5)
Total revenues	2,219.8	2,264.0
<b>Expenses</b>		
Benefits, claims and settlement expenses	1,191.5	1,275.3
Dividends to policyholders	53.6	56.5
Operating expenses	691.2	675.9
Total expenses	1,936.3	2,007.7
Income before income taxes	283.5	256.3
Income taxes	60.4	52.7
Net income	223.1	203.6
Net income attributable to noncontrolling interest	18.6	4.6
Net income attributable to Principal Financial Group, Inc.	204.5	199.0
Preferred stock dividends	8.2	8.2
Net income available to common stockholders	\$ 196.3	\$ 190.8
<b>Earnings per common share</b>		
Basic earnings per common share	\$ 0.61	\$ 0.60
Diluted earnings per common share	\$ 0.60	\$ 0.59

See accompanying notes.

Table of Contents

**Principal Financial Group, Inc.**  
**Consolidated Statements of Stockholders' Equity**  
**(Unaudited)**

	Series A preferred stock	Series B preferred stock	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Noncontrolling interest	Total stockholders equity
	(in millions)								
<b>Balances at January 1, 2010</b>	\$	\$ 0.1	\$ 4.5	\$ 9,492.9	\$ 4,160.7	\$ (1,042.0)	\$ (4,722.7)	\$ 122.9	\$ 8,016.4
Common stock issued				8.3					8.3
Stock-based compensation and additional related tax benefits				11.3					11.3
Treasury stock acquired, common							(1.7)		(1.7)
Dividends to preferred stockholders					(8.2)				(8.2)
Distributions to noncontrolling interest								(1.0)	(1.0)
Contributions from noncontrolling interest								5.9	5.9
Effects of implementation of accounting change related to variable interest entities, net					(10.7)	10.7			
<b>Comprehensive income:</b>									
Net income					199.0			4.6	203.6
Net unrealized gains, net						449.1			449.1
Noncredit component of impairment losses on fixed maturities, available-for-sale, net						(3.0)			(3.0)
Foreign currency translation adjustment, net of related income taxes						(2.6)		0.2	(2.4)
Unrecognized postretirement benefit obligation, net of related income taxes						9.9			9.9
<b>Comprehensive income</b>									657.2
<b>Balances at March 31, 2010</b>	\$	\$ 0.1	\$ 4.5	\$ 9,512.5	\$ 4,340.8	\$ (577.9)	\$ (4,724.4)	\$ 132.6	\$ 8,688.2
<b>Balances at January 1, 2011</b>	\$	\$ 0.1	\$ 4.5	\$ 9,563.8	\$ 4,612.3	\$ 272.4	\$ (4,725.3)	\$ 157.2	\$ 9,885.0
Common stock issued				9.1					9.1
Stock-based compensation and additional related tax benefits				9.2					9.2
Treasury stock acquired, common							(5.9)		(5.9)
Dividends to preferred stockholders					(8.2)				(8.2)
Distributions to noncontrolling interest								(2.4)	(2.4)
Contributions from noncontrolling interest								14.3	14.3
Purchase of subsidiary shares from noncontrolling interest				(2.0)				(2.5)	(4.5)
<b>Comprehensive income:</b>									
Net income					204.5			18.6	223.1
Net unrealized gains, net						164.6			164.6
Noncredit component of impairment losses on fixed maturities, available-for-sale,						16.6			16.6



Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

net																	
Foreign currency translation adjustment, net of related income taxes							22.7					22.7					
Unrecognized postretirement benefit obligation, net of related income taxes							49.2					49.2					
Comprehensive income												476.2					
<b>Balances at March 31, 2011</b>	<b>\$</b>	<b>\$</b>	<b>0.1</b>	<b>\$</b>	<b>4.5</b>	<b>\$</b>	<b>9,580.1</b>	<b>\$</b>	<b>4,808.6</b>	<b>\$</b>	<b>525.5</b>	<b>\$</b>	<b>(4,731.2)</b>	<b>\$</b>	<b>185.2</b>	<b>\$</b>	<b>10,372.8</b>

See accompanying notes.

Table of Contents

**Principal Financial Group, Inc.**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

	For the three months ended	
	2011	2010
	March 31,	
	(in millions)	
<b>Operating activities</b>		
Net income	\$ 223.1	\$ 203.6
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred policy acquisition costs	55.5	72.8
Additions to deferred policy acquisition costs	(127.0)	(123.8)
Accrued investment income	(9.5)	(32.1)
Net cash flows for trading securities	65.3	(148.8)
Premiums due and other receivables	(42.4)	(12.0)
Contractholder and policyholder liabilities and dividends	314.2	255.9
Current and deferred income taxes	48.9	37.6
Net realized capital losses	58.0	45.5
Depreciation and amortization expense	31.4	29.9
Mortgage loans held for sale, acquired or originated	(25.9)	(15.9)
Mortgage loans held for sale, sold or repaid, net of gain	15.9	13.7
Real estate sold through operating activities	76.9	3.1
Stock-based compensation	9.2	10.7
Other	501.9	313.0
Net adjustments	972.4	449.6
Net cash provided by operating activities	1,195.5	653.2
<b>Investing activities</b>		
Available-for-sale securities:		
Purchases	(1,666.4)	(2,228.5)
Sales	536.4	707.2
Maturities	1,725.6	828.5
Mortgage loans acquired or originated	(123.9)	(219.1)
Mortgage loans sold or repaid	323.7	451.5
Real estate acquired	(7.0)	(9.7)
Net purchases of property and equipment	(4.1)	(4.2)
Net change in other investments	(68.4)	12.3
Net cash provided by (used in) investing activities	\$ 715.9	\$ (462.0)

Table of Contents

**Principal Financial Group, Inc.**  
**Consolidated Statements of Cash Flows (continued)**  
**(Unaudited)**

	For the three months ended March 31,	
	2011	2010
	(in millions)	
<b>Financing activities</b>		
Issuance of common stock	\$ 9.1	\$ 8.3
Acquisition of treasury stock	(5.9)	(1.7)
Proceeds from financing element derivatives	19.4	16.6
Payments for financing element derivatives	(12.1)	(13.2)
Excess tax benefits from share-based payment arrangements	1.6	0.4
Dividends to preferred stockholders	(8.2)	(8.2)
Issuance of long-term debt	0.6	0.2
Principal repayments of long-term debt	(1.7)	(3.4)
Net proceeds from short-term borrowings	0.2	31.2
Investment contract deposits	893.3	1,051.0
Investment contract withdrawals	(2,674.2)	(1,920.7)
Net increase (decrease) in banking operation deposits	(25.8)	38.7
Other	(0.9)	(1.1)
Net cash used in financing activities	(1,804.6)	(801.9)
Net increase (decrease) in cash and cash equivalents	106.8	(610.7)
Cash and cash equivalents at beginning of period	1,877.4	2,240.4
Cash and cash equivalents at end of period	\$ 1,984.2	\$ 1,629.7

*See accompanying notes.*

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements**  
**March 31, 2011**  
**(Unaudited)**

**1. Nature of Operations and Significant Accounting Policies**

**Basis of Presentation**

The accompanying unaudited consolidated financial statements of Principal Financial Group, Inc. ( PFG ), its majority-owned subsidiaries and its consolidated variable interest entities ( VIEs ), have been prepared in conformity with accounting principles generally accepted in the U.S. ( U.S. GAAP ) for interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2011, are not necessarily indicative of the results that may be expected for the year ended December 31, 2011. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2010, included in our Form 10-K for the year ended December 31, 2010, filed with the United States Securities and Exchange Commission ( SEC ). The accompanying consolidated statement of financial position as of December 31, 2010, has been derived from the audited consolidated statement of financial position but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

**Recent Accounting Pronouncements**

In April 2011, the Financial Accounting Standards Board ( FASB ) issued authoritative guidance which clarifies when creditors should classify a loan modification as a troubled debt restructuring ( TDR ). A TDR occurs when a creditor grants a concession to a debtor experiencing financial difficulties. Loans denoted as a TDR are considered impaired and are specifically reserved for when calculating the allowance for credit losses. This guidance also ends the indefinite deferral issued in January 2011 surrounding new disclosures on loans classified as a TDR required as part of the credit quality disclosures guidance issued in July 2010. This guidance will be effective for us on July 1, 2011, and will be applied retrospectively to restructurings occurring on or after January 1, 2011. We are currently evaluating the impact this guidance will have on our consolidated financial statements.

In October 2010, the FASB issued authoritative guidance that modifies the definition of the types of costs incurred by insurance entities that can be capitalized in the successful acquisition of new or renewal insurance contracts. Capitalized costs should include incremental direct costs of contract acquisition, as well as certain costs related directly to acquisition activities such as underwriting, policy issuance and processing, medical and inspection and sales force contract selling. This guidance will be effective for us on January 1, 2012, with retrospective application permitted but not required. We are currently evaluating the impact this guidance will have on our consolidated financial statements.

In July 2010, the FASB issued authoritative guidance that requires new and expanded disclosures related to the credit quality of financing receivables and the allowance for credit losses. Reporting entities are required to provide qualitative and quantitative disclosures on the allowance for credit losses, credit quality, impaired loans, modifications and nonaccrual and past due financing receivables. The disclosures are

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

required to be presented on a disaggregated basis by portfolio segment and class of financing receivable. Disclosures required by the guidance that relate to the end of a reporting period were effective for us in our December 31, 2010, consolidated financial statements. Disclosures required by the guidance that relate to an activity that occurs during a reporting period were effective for us on January 1, 2011, and did not have a material impact on our consolidated financial statements. See Note 3, Investments, for further details.

In April 2010, the FASB issued authoritative guidance addressing how investments held through the separate accounts of an insurance entity affect the entity's consolidation analysis. This guidance clarifies that an insurance entity should not consider any separate account interests held for the benefit of policyholders in an investment to be the insurer's interests and should not combine those interests with its general account interest in the same investment when assessing the investment for consolidation. This guidance was effective for us on January 1, 2011, and did not have a material impact on our consolidated financial statements.

In March 2010, the FASB issued authoritative guidance that amends and clarifies the guidance on evaluation of credit derivatives embedded in beneficial interests in securitized financial assets, including asset-backed securities (ABS), credit-linked notes, collateralized loan obligations and collateralized debt obligations (CDOs). This guidance eliminates the scope exception for bifurcation of embedded credit derivatives in interests in securitized financial assets, unless they are created solely by subordination of one financial instrument to another. We adopted this guidance effective July 1, 2010, and within the scope of this guidance reclassified fixed maturities with a fair value of \$75.3 million, from available-for-sale to trading. The cumulative change in accounting principle related to unrealized losses on these fixed maturities resulted in a net \$25.4 million decrease to retained earnings, with a corresponding increase to accumulated other comprehensive income (AOCI).

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**1. Nature of Operations and Significant Accounting Policies (continued)**

In January 2010, the FASB issued authoritative guidance that requires new disclosures related to fair value measurements and clarifies existing disclosure requirements about the level of disaggregation, inputs and valuation techniques. Specifically, reporting entities now must disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers. In addition, in the reconciliation for Level 3 fair value measurements, a reporting entity should present separately information about purchases, sales, issuances and settlements. The guidance clarifies that a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities for disclosure of fair value measurement, considering the level of disaggregated information required by other applicable U.S. GAAP guidance and should also provide disclosures about the valuation techniques and inputs used to measure fair value for each class of assets and liabilities. This guidance was effective for us on January 1, 2010, except for the disclosures about purchases, sales, issuances and settlements in the reconciliation for Level 3 fair value measurements, which were effective for us on January 1, 2011. This guidance did not have a material impact on our consolidated financial statements. See Note 9, Fair Value Measurements, for further details.

In June 2009, the FASB issued authoritative guidance related to the accounting for VIEs, which amends prior guidance and requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a VIE. This analysis identifies the primary beneficiary of a VIE as the enterprise with (1) the power to direct the activities of a VIE that most significantly impact the enterprise's economic performance and (2) the obligation to absorb losses of the enterprise or the right to receive benefits from the enterprise that could potentially be significant to the VIE. In addition, this guidance requires ongoing reassessments of whether an enterprise is the primary beneficiary of a VIE. Furthermore, we are required to enhance disclosures that will provide users of financial statements with more transparent information about an enterprise's involvement in a VIE. We adopted this guidance prospectively effective January 1, 2010. Due to the implementation of this guidance, certain previously unconsolidated VIEs were consolidated and certain previously consolidated VIEs were deconsolidated. The cumulative change in accounting principle from adopting this guidance resulted in a net \$10.7 million decrease to retained earnings and a net \$10.7 million increase to AOCI. In February 2010, the FASB issued an amendment to this guidance. The amendment indefinitely defers the consolidation requirements for reporting enterprises' interests in entities that have the characteristics of investment companies and regulated money market funds. This amendment was effective January 1, 2010, and did not have a material impact to our consolidated financial statements. The required disclosures are included in our consolidated financial statements. See Note 2, Variable Interest Entities, for further details.

**Separate Accounts**

At March 31, 2011 and December 31, 2010, the separate accounts include a separate account valued at \$209.7 million and \$221.7 million, respectively, which primarily includes shares of our stock that were allocated and issued to eligible participants of qualified employee benefit plans administered by us as part of the policy credits issued under our 2001 demutualization. These shares are included in both basic and diluted earnings per share calculations. In the consolidated statements of financial position, the separate account shares are recorded at fair value and are reported as separate account assets with a corresponding separate account liability to eligible participants of the qualified plan. Changes in fair value of the separate account shares are reflected in both the separate account assets and separate account liabilities and do not impact our results of operations.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**2. Variable Interest Entities**

We have relationships with and may have a variable interest in various types of special purpose entities. Following is a discussion of our interest in entities that meet the definition of a VIE. When we are the primary beneficiary, we are required to consolidate the entity in our financial statements. The primary beneficiary of a VIE is defined as the enterprise with (1) the power to direct the activities of a VIE that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE. We assess whether we are the primary beneficiary of VIEs we have relationships with on an ongoing basis.

**Consolidated Variable Interest Entities**

***Grantor Trusts***

We contributed undated subordinated floating rate notes to three grantor trusts. The trusts separated the cash flows by issuing an interest-only certificate and a residual certificate related to each note contributed. Each interest-only certificate entitles the holder to interest on the stated note for a specified term, while the residual certificate entitles the holder to interest payments subsequent to the term of the interest-only certificate and to all principal payments. We retained the interest-only certificates and the residual certificates were subsequently sold to third parties. We have determined these grantor trusts are VIEs due to insufficient equity to sustain them. We determined we are the primary beneficiary as a result of our contribution of securities into the trusts and our continuing interest in the trusts.

***Collateralized Private Investment Vehicles***

We invest in synthetic CDOs, collateralized bond obligations, collateralized loan obligations, collateralized commodity obligations and other collateralized structures, which are VIEs due to insufficient equity to sustain the entities (collectively known as collateralized private investment vehicles). The performance of the notes of these structures is primarily linked to a synthetic portfolio by derivatives; each note has a specific loss attachment and detachment point. The notes and related derivatives are collateralized by a pool of permitted investments. The investments are held by a trustee and can only be liquidated to settle obligations of the trusts. These obligations primarily include derivatives, financial guarantees and the notes due at maturity or termination of the trusts. We determined we are the primary beneficiary for certain of these entities because we act as the investment manager of the underlying portfolio and we have an ownership interest.

***Commercial Mortgage-Backed Securities***



In September 2000, we sold commercial mortgage loans to a real estate mortgage investment conduit trust. The trust issued various commercial mortgage-backed securities ( CMBS ) certificates using the cash flows of the underlying commercial mortgages it purchased. This is considered a VIE due to insufficient equity to sustain itself. We have determined we are the primary beneficiary as we retained the special servicing role for the assets within the trust as well as the ownership of the bond class which controls the unilateral kick out rights of the special servicer.

***Hedge Funds***

We are a general partner with an insignificant equity ownership in various hedge funds. These entities are deemed VIEs due to the equity owners not having decision-making ability. We have determined we are the primary beneficiary of these entities due to our control through our management relationship, related party ownership and our fee structure in certain of these funds.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**2. Variable Interest Entities (continued)**

The carrying amounts of our consolidated VIE assets, which can only be used to settle obligations of consolidated VIEs, and liabilities of consolidated VIEs for which creditors do not have recourse are as follows:

	Grantor trusts	Collateralized private investment vehicles	CMBS (in millions)	Hedge funds (2)	Total
<b>March 31, 2011</b>					
Fixed maturities, available-for-sale	\$ 248.0	\$ 14.9	\$	\$	\$ 262.9
Fixed maturities, trading		135.0			135.0
Equity securities, trading				218.6	218.6
Other investments			122.2	0.3	122.5
Cash and cash equivalents		55.0		58.7	113.7
Accrued investment income	0.9	0.1	0.8		1.8
Premiums due and other receivables		1.5		48.1	49.6
<b>Total assets</b>	<b>\$ 248.9</b>	<b>\$ 206.5</b>	<b>\$ 123.0</b>	<b>\$ 325.7</b>	<b>\$ 904.1</b>
Deferred income taxes	\$ 2.3	\$	\$	\$	\$ 2.3
Other liabilities (1)	140.2	140.8	88.3	148.4	517.7
<b>Total liabilities</b>	<b>\$ 142.5</b>	<b>\$ 140.8</b>	<b>\$ 88.3</b>	<b>\$ 148.4</b>	<b>\$ 520.0</b>
<b>December 31, 2010</b>					
Fixed maturities, available-for-sale	\$ 243.1	\$ 14.8	\$	\$	\$ 257.9
Fixed maturities, trading		131.4			131.4
Equity securities, trading				158.6	158.6
Other investments			128.4	0.3	128.7
Cash and cash equivalents		55.0		45.0	100.0
Accrued investment income	0.7	0.1	0.8		1.6
Premiums due and other receivables		1.6		13.9	15.5
<b>Total assets</b>	<b>\$ 243.8</b>	<b>\$ 202.9</b>	<b>\$ 129.2</b>	<b>\$ 217.8</b>	<b>\$ 793.7</b>
Deferred income taxes	\$ 2.4	\$	\$	\$	\$ 2.4
Other liabilities (1)	135.8	132.6	94.1	71.1	433.6
<b>Total liabilities</b>	<b>\$ 138.2</b>	<b>\$ 132.6</b>	<b>\$ 94.1</b>	<b>\$ 71.1</b>	<b>\$ 436.0</b>

(1) Grantor trusts contain an embedded derivative of a forecasted transaction to deliver the underlying securities; collateralized private investment vehicles include derivative liabilities, financial guarantees and obligation to redeem notes at maturity or termination of the trust; CMBS includes obligation to the bondholders; and hedge funds include liabilities to securities brokers.

(2) The consolidated statements of financial position included a \$176.5 million and \$145.9 million noncontrolling interest for hedge funds as of March 31, 2011 and December 31, 2010, respectively.

We did not provide financial or other support to investees designated as VIEs for the three months ended March 31, 2011 and 2010.

#### **Unconsolidated Variable Interest Entities**

##### *Invested Securities*

We hold a variable interest in a number of VIEs where we are not the primary beneficiary. Our investments in securities issued by these VIEs are reported in fixed maturities, available-for-sale and fixed maturities, trading in the consolidated statements of financial position and are described below.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**2. Variable Interest Entities (continued)**

VIEs include CMBS, residential mortgage-backed pass-through securities ( RMBS ) and ABS. All of these entities were deemed VIEs because the equity within these entities is insufficient to sustain them. We determined we are not the primary beneficiary in any of the entities within these categories of investments. This determination was based primarily on the fact we do not own the class of security that controls the unilateral right to replace the special servicer or equivalent function.

As previously discussed, we invest in several types of collateralized private investment vehicles, which are VIEs. These include cash and synthetic structures that we do not manage. We have determined we are not the primary beneficiary of these collateralized private investment vehicles primarily because we do not control the economic performance of the entities and were not involved with the design of the entities.

We have invested in various VIE trusts as a debt holder. All of these entities are classified as VIEs due to insufficient equity to sustain them. We have determined we are not the primary beneficiary primarily because we do not control the economic performance of the entities and were not involved with the design of the entities.

The carrying value and maximum loss exposure for our unconsolidated VIEs, were as follows:

	Asset carrying value	Maximum exposure to loss (1)
	(in millions)	
<b>March 31, 2011</b>		
Fixed maturities, available-for-sale:		
Corporate	\$ 444.0	\$ 382.5
Residential mortgage-backed pass-through securities	3,168.6	3,066.7
Commercial mortgage-backed securities	3,940.2	4,278.0
Collateralized debt obligations	300.3	359.8
Other debt obligations	3,197.5	3,243.8
Fixed maturities, trading:		
Residential mortgage-backed pass-through securities	122.4	122.4
Commercial mortgage-backed securities	47.9	47.9
Collateralized debt obligations	78.3	78.3
Other debt obligations	88.3	88.3
<b>December 31, 2010</b>		
Fixed maturities, available-for-sale:		
Corporate	\$ 429.0	\$ 367.7
Residential mortgage-backed pass-through securities	3,196.2	3,077.9

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Commercial mortgage-backed securities	3,842.2	4,424.9
Collateralized debt obligations	293.0	380.5
Other debt obligations	3,114.1	3,184.9
Fixed maturities, trading:		
Residential mortgage-backed pass-through securities	215.5	215.5
Commercial mortgage-backed securities	5.1	5.1
Collateralized debt obligations	87.2	87.2
Other debt obligations	118.8	118.8

---

(1) Our risk of loss is limited to our initial investment measured at amortized cost for fixed maturities, available-for-sale and to fair value for our fixed maturities, trading.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**2. Variable Interest Entities (continued)**

*Sponsored Investment Funds*

We are the investment manager for certain money market mutual funds that are deemed to be VIEs. We are not the primary beneficiary of these VIEs since our involvement is limited primarily to being a service provider, and our variable interest does not absorb the majority of the variability of the entities' net assets. As of March 31, 2011 and December 31, 2010, these VIEs held \$1.6 billion and \$1.7 billion in total assets, respectively. During 2010, we chose to contribute \$3.2 million to these VIEs for competitive reasons and have no contractual obligation to further contribute to the funds.

We provide asset management and other services to certain investment structures that are considered VIEs as we generally earn management fees and in some instances performance-based fees. We are not the primary beneficiary of these entities as we do not have the obligation to absorb losses of the entities that could be potentially significant to the VIE or the right to receive benefits from these entities that could be potentially significant.

**3. Investments**

**Fixed Maturities and Equity Securities**

Fixed maturities include bonds, ABS, redeemable preferred stock and certain nonredeemable preferred stock. Equity securities include mutual funds, common stock and nonredeemable preferred stock. We classify fixed maturities and equity securities as either available-for-sale or trading at the time of the purchase and, accordingly, carry them at fair value. See Note 9, Fair Value Measurements, for methodologies related to the determination of fair value. Unrealized gains and losses related to available-for-sale securities, excluding those in fair value hedging relationships, are reflected in stockholders' equity, net of adjustments related to deferred policy acquisition costs ( DPAC ), sales inducements, unearned revenue reserves, derivatives in cash flow hedge relationships and applicable income taxes. Unrealized gains and losses related to hedged portions of available-for-sale securities in fair value hedging relationships and mark-to-market adjustments on certain trading securities are reflected in net realized capital gains (losses). We also have trading securities portfolios that support investment strategies that involve the active and frequent purchase and sale of fixed maturities. Mark-to-market adjustments related to these trading securities are reflected in net investment income.

The cost of fixed maturities is adjusted for amortization of premiums and accrual of discounts, both computed using the interest method. The cost of fixed maturities and equity securities classified as available-for-sale is adjusted for declines in value that are other than temporary.

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Impairments in value deemed to be other than temporary are primarily reported in net income as a component of net realized capital gains (losses), with noncredit impairment losses for certain fixed maturities, available-for-sale reported in other comprehensive income ( OCI ). For loan-backed and structured securities, we recognize income using a constant effective yield based on currently anticipated cash flows.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

The amortized cost, gross unrealized gains and losses, other-than-temporary impairments in AOCI and fair value of fixed maturities and equity securities available-for-sale are summarized as follows:

	Amortized cost	Gross unrealized gains	Gross unrealized losses (in millions)	Other-than- temporary impairments in AOCI (1)	Fair value
<b>March 31, 2011</b>					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 532.6	\$ 18.7	\$ 0.3	\$	\$ 551.0
Non-U.S. governments	731.3	99.0	2.1		828.2
States and political subdivisions	2,625.3	63.2	23.4		2,665.1
Corporate	32,227.6	1,860.5	416.5	17.0	33,654.6
Residential mortgage-backed pass-through securities	3,066.7	111.6	9.7		3,168.6
Commercial mortgage-backed securities	4,278.0	140.4	301.5	176.7	3,940.2
Collateralized debt obligations	359.8	2.7	45.6	16.6	300.3
Other debt obligations	3,243.8	54.9	15.4	85.8	3,197.5
Total fixed maturities, available-for-sale	\$ 47,065.1	\$ 2,351.0	\$ 814.5	\$ 296.1	\$ 48,305.5
Total equity securities, available-for-sale	\$ 174.0	\$ 11.8	\$ 10.0		\$ 175.8
<b>December 31, 2010</b>					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 748.5	\$ 21.0	\$ 0.2	\$	\$ 769.3
Non-U.S. governments	744.7	127.9			872.6
States and political subdivisions	2,615.0	64.7	23.3		2,656.4
Corporate	32,523.8	1,913.7	527.0	18.0	33,892.5
Residential mortgage-backed pass-through securities	3,077.9	124.2	5.9		3,196.2
Commercial mortgage-backed securities	4,424.9	118.0	506.1	194.6	3,842.2
Collateralized debt obligations	380.5	1.7	51.8	37.4	293.0
Other debt obligations	3,184.9	53.7	40.0	84.5	3,114.1
Total fixed maturities, available-for-sale	\$ 47,700.2	\$ 2,424.9	\$ 1,154.3	\$ 334.5	\$ 48,636.3
Total equity securities, available-for-sale	\$ 180.0	\$ 8.1	\$ 18.2		\$ 169.9



Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

(1) Excludes \$124.0 million and \$58.6 million as of March 31, 2011 and December 31, 2010, respectively, of net unrealized gains on impaired fixed maturities, available-for-sale related to changes in fair value subsequent to the impairment date.

The amortized cost and fair value of fixed maturities available-for-sale at March 31, 2011, by expected maturity, were as follows:

	Amortized cost	(in millions)	Fair value
Due in one year or less	\$	2,292.9	\$ 2,341.1
Due after one year through five years		13,295.6	13,854.3
Due after five years through ten years		8,771.2	9,218.1
Due after ten years		11,757.1	12,285.4
Subtotal		36,116.8	37,698.9
Mortgage-backed and other asset-backed securities		10,948.3	10,606.6
Total	\$	47,065.1	\$ 48,305.5

Actual maturities may differ because borrowers may have the right to call or prepay obligations. Our portfolio is diversified by industry, issuer and asset class. Credit concentrations are managed to established limits.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)****Net Realized Capital Gains and Losses**

Net realized capital gains and losses on sales of investments are determined on the basis of specific identification. In general, in addition to realized capital gains and losses on investment sales and periodic settlements on derivatives not designated as hedges, we report gains and losses related to the following in net realized capital gains (losses): other-than-temporary impairments of securities and subsequent recoveries, mark-to-market adjustments on certain trading securities, mark-to-market adjustments on certain seed money investments, fair value hedge and cash flow hedge ineffectiveness, mark-to-market adjustments on derivatives not designated as hedges, changes in the mortgage loan valuation allowance provision and subsequent commercial mortgage loan recoveries and impairments of real estate held for investment. Investment gains and losses on sales of certain real estate held for sale, which do not meet the criteria for classification as a discontinued operation and mark-to-market adjustments on trading securities that support investment strategies that involve the active and frequent purchase and sale of fixed maturities are reported as net investment income and are excluded from net realized capital gains (losses). The major components of net realized capital gains (losses) on investments are summarized as follows:

	For the three months ended March 31,	
	2011	2010
	(in millions)	
Fixed maturities, available-for-sale:		
Gross gains	\$ 12.5	\$ 19.0
Gross losses	(23.3)	(93.6)
Other-than-temporary impairment losses reclassified to (from) OCI	(38.4)	5.4
Hedging, net	(30.2)	46.7
Fixed maturities, trading	(4.6)	10.5
Equity securities, available-for-sale:		
Gross gains	2.2	7.5
Gross losses		(1.5)
Equity securities, trading	30.1	7.9
Mortgage loans	(9.9)	(26.0)
Derivatives	8.9	(49.7)
Other	(5.3)	28.3
Net realized capital losses	\$ (58.0)	\$ (45.5)

Proceeds from sales of investments (excluding call and maturity proceeds) in fixed maturities, available-for-sale were \$0.5 billion and \$0.6 billion for the three months ended March 31, 2011 and 2010, respectively.

**Other-Than-Temporary Impairments**

We have a process in place to identify fixed maturity and equity securities that could potentially have a credit impairment that is other than temporary. This process involves monitoring market events that could impact issuers' credit ratings, business climate, management changes, litigation and government actions and other similar factors. This process also involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues.

Each reporting period, all securities are reviewed to determine whether an other-than-temporary decline in value exists and whether losses should be recognized. We consider relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events; (4) for structured securities, the adequacy of the expected cash flows; (5) for fixed maturities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and (6) for equity securities, our ability and intent to hold the security for a period of time that allows for the recovery in value. To the extent we determine that a security is deemed to be other than temporarily impaired, an impairment loss is recognized.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

Impairment losses on equity securities are recognized in net income and are measured as the difference between amortized cost and fair value. The way in which impairment losses on fixed maturities are recognized in the financial statements is dependent on the facts and circumstances related to the specific security. If we intend to sell a security or it is more likely than not that we would be required to sell a security before the recovery of its amortized cost, we recognize an other-than-temporary impairment in net income for the difference between amortized cost and fair value. If we do not expect to recover the amortized cost basis, we do not plan to sell the security and if it is not more likely than not that we would be required to sell a security before the recovery of its amortized cost, the recognition of the other-than-temporary impairment is bifurcated. We recognize the credit loss portion in net income and the noncredit loss portion in OCI ( bifurcated OTTI ).

Total other-than-temporary impairment losses, net of recoveries from the sale of previously impaired securities, were as follows:

	For the three months ended March 31,	
	2011	2010
	(in millions)	
Fixed maturities, available-for-sale	\$ (16.2)	\$ (88.6)
Equity securities, available-for-sale	2.2	4.0
Total other-than-temporary impairment losses, net of recoveries from the sale of previously impaired securities	(14.0)	(84.6)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) OCI (1)	(38.4)	5.4
Net impairment losses on available-for-sale securities	\$ (52.4)	\$ (79.2)

(1) Represents the net impact of (1) gains resulting from reclassification of noncredit impairment losses for fixed maturities with bifurcated OTTI from net realized capital gains (losses) to OCI and (2) losses resulting from reclassification of previously recognized noncredit impairment losses from OCI to net realized capital gains (losses) for fixed maturities with bifurcated OTTI that had additional credit losses or fixed maturities that previously had bifurcated OTTI that have now been sold or are intended to be sold.

We estimate the amount of the credit loss component of a fixed maturity security impairment as the difference between amortized cost and the present value of the expected cash flows of the security. The present value is determined using the best estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best estimate cash flows vary depending on the type of security. The ABS cash flow estimates are based on security specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds and structural support, including subordination and guarantees. The corporate security cash flow estimates are derived from scenario-based outcomes of expected corporate restructurings or liquidations using bond specific facts and circumstances including timing, security interests and loss severity.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

The following table provides a rollforward of accumulated credit losses for fixed maturities with bifurcated credit losses. The purpose of the table is to provide detail of (1) additions to the bifurcated credit loss amounts recognized in net realized capital gains (losses) during the period and (2) decrements for previously recognized bifurcated credit losses where the loss is no longer bifurcated and/or there has been a positive change in expected cash flows or accretion of the bifurcated credit loss amount.

	For the three months ended March 31,	
	2011	2010
	(in millions)	
Beginning balance	\$ (325.7)	\$ (204.7)
Credit losses for which an other-than-temporary impairment was not previously recognized	(2.2)	(54.8)
Credit losses for which an other-than-temporary impairment was previously recognized	(34.5)	(22.2)
Reduction for credit losses previously recognized on fixed maturities now sold or intended to be sold	51.2	18.6
Reduction for positive changes in cash flows expected to be collected and amortization (1)	(0.9)	0.4
Ending balance	\$ (312.1)	\$ (262.7)

(1) Amounts are recognized in net investment income.

**Gross Unrealized Losses for Fixed Maturities and Equity Securities**

For fixed maturities and equity securities available-for-sale with unrealized losses, including other-than-temporary impairment losses reported in OCI, the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are summarized as follows:

	Less than twelve months		March 31, 2011 Greater than or equal to twelve months		Total
	Carrying value	Gross unrealized losses	Carrying value	Gross unrealized losses	
	(in millions)				
Fixed maturities, available-for-sale:					

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

U.S. government and agencies	\$	43.0	\$	0.3	\$		\$	43.0	\$	0.3
Non-U.S. governments		37.8		2.1				37.8		2.1
States and political subdivisions		766.8		17.0		45.4		6.4		812.2
Corporate		2,352.0		57.5		3,406.8		376.0		5,758.8
Residential mortgage-backed pass-through securities		641.9		9.4		5.5		0.3		647.4
Commercial mortgage-backed securities		456.5		7.5		1,147.7		470.7		1,604.2
Collateralized debt obligations		9.3		0.2		226.5		62.0		235.8
Other debt obligations		435.0		7.3		526.6		93.9		961.6
Total fixed maturities, available-for-sale	\$	4,742.3	\$	101.3	\$	5,358.5	\$	1,009.3	\$	10,100.8
Total equity securities, available-for-sale	\$	9.1	\$	0.3	\$	83.3	\$	9.7	\$	92.4
	\$		\$		\$		\$		\$	

Of the total amounts, Principal Life's consolidated portfolio represented \$9,672.6 million in available-for-sale fixed maturities with gross unrealized losses of \$1,067.5 million. Principal Life's consolidated portfolio consists of fixed maturities where 78% were investment grade (rated AAA through BBB-) with an average price of 90 (carrying value/amortized cost) at March 31, 2011. Gross unrealized losses in our fixed maturities portfolio decreased during the three months ended March 31, 2011, due to a tightening of credit spreads primarily in the corporate and commercial mortgage-backed securities sectors, partially offset by an increase in interest rates.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

For those securities that had been in a continuous unrealized loss position for less than twelve months, Principal Life's consolidated portfolio held 567 securities with a carrying value of \$4,437.0 million and unrealized losses of \$90.6 million reflecting an average price of 98 at March 31, 2011. Of this portfolio, 96% was investment grade (rated AAA through BBB-) at March 31, 2011, with associated unrealized losses of \$83.1 million. The unrealized losses on these securities can primarily be attributed to changes in market interest rates and changes in credit spreads since the securities were acquired.

For those securities that had been in a continuous unrealized loss position greater than or equal to twelve months, Principal Life's consolidated portfolio held 699 securities with a carrying value of \$5,235.6 million and unrealized losses of \$976.9 million. The average rating of this portfolio was BBB with an average price of 84 at March 31, 2011. Of the \$976.9 million in unrealized losses, the commercial mortgage-backed securities sector accounts for \$470.8 million in unrealized losses with an average price of 71 and an average credit rating of BBB-. The remaining unrealized losses consist primarily of \$343.7 million within the corporate sector at March 31, 2011. The average price of the corporate sector was 91 and the average credit rating was BBB. The unrealized losses on these securities can primarily be attributed to changes in market interest rates and changes in credit spreads since the securities were acquired.

Because we expected to recover our amortized cost, it was not our intent to sell the fixed maturity available-for-sale securities with unrealized losses and it was not more likely than not that we would be required to sell these securities before recovery of the amortized cost, which may be maturity, we did not consider these investments to be other-than-temporarily impaired at March 31, 2011.

	Less than twelve months		December 31, 2010 Greater than or equal to twelve months		Total	
	Carrying value	Gross unrealized losses	Carrying value	Gross unrealized losses	Carrying value	Gross unrealized losses
	(in millions)					
Fixed maturities, available-for-sale:						
U.S. government and agencies	\$ 224.5	\$ 0.2	\$	\$	\$ 224.5	\$ 0.2
Non-U.S. governments	7.9				7.9	
States and political subdivisions	771.0	18.4	44.2	4.9	815.2	23.3
Corporate	2,457.4	69.1	3,948.9	475.9	6,406.3	545.0
Residential mortgage-backed pass-through securities	384.9	5.9			384.9	5.9
Commercial mortgage-backed securities	340.1	4.9	1,186.4	695.8	1,526.5	700.7
Collateralized debt obligations	10.4	0.5	233.0	88.7	243.4	89.2
Other debt obligations	401.5	8.4	578.4	116.1	979.9	124.5
Total fixed maturities, available-for-sale	\$ 4,597.7	\$ 107.4	\$ 5,990.9	\$ 1,381.4	\$ 10,588.6	\$ 1,488.8



Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Total equity securities, available-for-sale	\$	47.3	\$	7.2	\$	77.0	\$	11.0	\$	124.3	\$	18.2
--	----	------	----	-----	----	------	----	------	----	-------	----	------

Of the total amounts, Principal Life's consolidated portfolio represented \$9,914.2 million in available-for-sale fixed maturities with gross unrealized losses of \$1,445.3 million. Principal Life's consolidated portfolio consists of fixed maturities where 77% were investment grade (rated AAA through BBB-) with an average price of 87 (carrying value/amortized cost) at December 31, 2010. Gross unrealized losses in our fixed maturities portfolio decreased during the year ended December 31, 2010, due to a decline in interest rates and a tightening of credit spreads primarily in the corporate and commercial mortgage-backed securities sectors.

For those securities that had been in a continuous unrealized loss position for less than twelve months, Principal Life's consolidated portfolio held 534 securities with a carrying value of \$4,112.3 million and unrealized losses of \$95.7 million reflecting an average price of 98 at December 31, 2010. Of this portfolio, 94% was investment grade (rated AAA through BBB-) at December 31, 2010, with associated unrealized losses of \$88.7 million. The unrealized losses on these securities can primarily be attributed to changes in market interest rates and changes in credit spreads since the securities were acquired.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

For those securities that had been in a continuous unrealized loss position greater than or equal to twelve months, Principal Life's consolidated portfolio held 773 securities with a carrying value of \$5,801.9 million and unrealized losses of \$1,349.6 million. The average rating of this portfolio was BBB with an average price of 81 at December 31, 2010. Of the \$1,349.6 million in unrealized losses, the commercial mortgage-backed securities sector accounts for \$695.8 million in unrealized losses with an average price of 63 and an average credit rating of BBB. The remaining unrealized losses consist primarily of \$444.1 million within the corporate sector at December 31, 2010. The average price of the corporate sector was 89 and the average credit rating was BBB. The unrealized losses on these securities can primarily be attributed to changes in market interest rates and changes in credit spreads since the securities were acquired.

Because we expected to recover our amortized cost, it was not our intent to sell the fixed maturity available-for-sale securities with unrealized losses and it was not more likely than not that we would be required to sell these securities before recovery of the amortized cost, which may be maturity, we did not consider these investments to be other-than-temporarily impaired at December 31, 2010.

**Net Unrealized Gains and Losses on Available-for-Sale Securities and Derivative Instruments**

The net unrealized gains and losses on investments in fixed maturities available-for-sale, equity securities available-for-sale and derivative instruments are reported as a separate component of stockholders' equity. The cumulative amount of net unrealized gains and losses on available-for-sale securities and derivative instruments net of adjustments related to DPAC, sales inducements, unearned revenue reserves, changes in policyholder liabilities and applicable income taxes was as follows:

	March 31, 2011	(in millions)	December 31, 2010
Net unrealized gains on fixed maturities, available-for-sale (1)	\$ 1,536.5		\$ 1,197.7
Noncredit component of impairment losses on fixed maturities, available-for-sale	(296.1)		(334.5)
Net unrealized gains (losses) on equity securities, available-for-sale	1.8		(10.1)
Adjustments for assumed changes in amortization patterns	(350.5)		(273.8)
Adjustments for assumed changes in policyholder liabilities	(186.7)		(212.4)
Net unrealized gains on derivative instruments	44.3		53.5
Net unrealized gains on equity method subsidiaries and noncontrolling interest adjustments	144.4		145.2
Provision for deferred income taxes	(279.8)		(169.0)
Effects of implementation of accounting change related to variable interest entities, net			10.7
Effects of electing fair value option for fixed maturities upon implementation of accounting changes related to embedded credit derivatives, net			25.4

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Net unrealized gains on available-for-sale securities and derivative instruments	\$	<b>613.9</b>	\$	432.7
--	----	--------------	----	-------

---

(1) Excludes net unrealized gains (losses) on fixed maturities, available-for-sale included in fair value hedging relationships.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)****Mortgage Loans**

Mortgage loans consist of commercial and residential mortgage loans. We evaluate risks inherent in our commercial mortgage loans in two classes: (1) brick and mortar property loans, where we analyze the property's rent payments as support for the loan, and (2) credit tenant loans (CTL), where we rely on the credit analysis of the tenant for the repayment of the loan. We evaluate risks inherent in our residential mortgage loan portfolio in two classes: (1) home equity mortgages and (2) first lien mortgages. The carrying amount of our mortgage loan portfolio was as follows:

	March 31, 2011		December 31, 2010
	(in millions)		
Commercial mortgage loans	\$ 9,515.5	\$	9,689.6
Residential mortgage loans	1,509.2		1,556.6
Total amortized cost	11,024.7		11,246.2
Valuation allowance	(124.7)		(121.1)
Total carrying value	\$ 10,900.0	\$	11,125.1

We periodically purchase mortgage loans as well as sell mortgage loans we have originated. We purchased \$42.1 million of residential mortgage loans during the three months ended March 31, 2011. We sold \$16.0 million of residential mortgage loans during the three months ended March 31, 2011.

Our commercial mortgage loan portfolio consists primarily of non-recourse, fixed rate mortgages on fully or near fully leased properties. Commercial mortgage loans represent a primary area of credit risk exposure.

Our commercial mortgage loan portfolio is diversified by geographic region and specific collateral property type as follows:

	March 31, 2011		December 31, 2010	
	Amortized cost	Percent of total	Amortized cost	Percent of total
	(\$ in millions)			
<b>Geographic distribution</b>				

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

New England	\$	428.1	4.5%	\$	430.3	4.5%
Middle Atlantic		1,657.4	17.4		1,648.4	17.0
East North Central		815.2	8.6		841.1	8.7
West North Central		429.3	4.5		466.7	4.8
South Atlantic		2,267.7	23.8		2,358.1	24.3
East South Central		229.9	2.4		231.5	2.4
West South Central		560.8	5.9		548.6	5.7
Mountain		655.6	6.9		691.0	7.1
Pacific		2,462.4	25.9		2,464.5	25.4
International		9.1	0.1		9.4	0.1
Total	\$	9,515.5	100.0%	\$	9,689.6	100.0%
<b>Property type distribution</b>						
Office	\$	2,788.9	29.3%	\$	2,886.2	29.8%
Retail		2,473.9	26.0		2,503.0	25.8
Industrial		2,326.1	24.4		2,334.5	24.1
Apartments		1,099.1	11.6		1,138.1	11.7
Hotel		464.2	4.9		471.8	4.9
Mixed use/other		363.3	3.8		356.0	3.7
Total	\$	9,515.5	100.0%	\$	9,689.6	100.0%

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

Our residential mortgage loan portfolio is composed of home equity mortgages with an amortized cost of \$688.9 million and \$719.3 million and first lien mortgages with an amortized cost of \$820.3 million and \$837.3 million as of March 31, 2011 and December 31, 2010, respectively. Most of our residential home equity mortgages are concentrated in the United States and are generally second lien mortgages comprised of closed-end loans and lines of credit. The majority of our first lien loans are concentrated in the Chilean market.

**Mortgage Loan Credit Monitoring***Commercial Credit Risk Profile Based on Internal Rating*

We actively monitor and manage our commercial mortgage loan portfolio. All commercial mortgage loans are analyzed regularly and substantially all are internally rated, based on a proprietary risk rating cash flow model, in order to monitor the financial quality of these assets. The model stresses expected cash flows at various levels and at different points in time depending on the durability of the income stream, which includes our assessment of factors such as location (macro and micro markets), tenant quality and lease expirations. Our internal rating analysis results in expected credit losses comparable to equivalent bond ratings. Internal ratings on commercial mortgage loans are updated at least annually and potentially more often for certain loans with material changes in collateral value or occupancy and for loans on an internal watch list.

Commercial mortgage loans that require more frequent and detailed attention than other loans in our portfolio are identified and placed on an internal watch list. Among the criteria that would indicate a potential problem are imbalances in ratios of loan to value or contract rents to debt service, major tenant vacancies or bankruptcies, borrower sponsorship problems, late payments, delinquent taxes and loan relief/restructuring requests.

Our commercial mortgage loan portfolio by credit risk, as determined by our internal rating system expressed in terms of an S&P bond equivalent rating, was as follows:

	Brick and mortar	March 31, 2011 CTL (in millions)	Total
A- and above	\$ 4,806.7	\$ 316.2	\$ 5,122.9
BBB+ thru BBB-	2,405.0	237.9	2,642.9

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

BB+ thru BB-	703.1	38.0	741.1
B+ and below	1,004.8	3.8	1,008.6
Total	\$ 8,919.6	\$ 595.9	\$ 9,515.5

	Brick and mortar	December 31, 2010 CTL (in millions)	Total
A- and above	\$ 4,781.8	\$ 324.7	\$ 5,106.5
BBB+ thru BBB-	2,636.1	249.5	2,885.6
BB+ thru BB-	726.1	38.5	764.6
B+ and below	929.0	3.9	932.9
Total	\$ 9,073.0	\$ 616.6	\$ 9,689.6

*Residential Credit Risk Profile Based on Performance Status*

Our residential mortgage loan portfolio is monitored based on performance of the loans. Monitoring on a residential mortgage loan increases when the loan is delinquent or earlier if there is an indication of impairment. We define non-performing residential mortgage loans as loans 90 days or greater delinquent or on non-accrual status.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

Our performing and non-performing residential mortgage loans were as follows:

	Home equity	March 31, 2011 First liens (in millions)		Total
Performing	\$ 673.1	\$ 794.3		\$ 1,467.4
Nonperforming	15.8	26.0		41.8
Total	\$ 688.9	\$ 820.3		\$ 1,509.2

	Home equity	December 31, 2010 First liens (in millions)		Total
Performing	\$ 705.0	\$ 811.6		\$ 1,516.6
Nonperforming	14.3	25.7		40.0
Total	\$ 719.3	\$ 837.3		\$ 1,556.6

**Non-Accrual Mortgage Loans**

Commercial and residential mortgage loans are placed on non-accrual status if we have concern regarding the collectability of future payments or if a loan has matured without being paid off or extended. Factors considered may include conversations with the borrower, loss of major tenant, bankruptcy of borrower or major tenant, decreased property cash flow for commercial mortgage loans or number of days past due for residential mortgage loans. Based on an assessment as to the collectability of the principal, a determination is made to apply any payments received either against the principal or according to the contractual terms of the loan. When a loan is placed on nonaccrual status, the accrued unpaid interest receivable is reversed against interest income. Accrual of interest resumes after factors resulting in doubts about collectability have improved. Residential first lien mortgages in the Chilean market are carried on accrual for longer than domestic loans as assessment of collectability is based on the nature of the loans and collection practices in that market.

Mortgage loans on non-accrual status were as follows:

	March 31, 2011 (in millions)		December 31, 2010
Commercial:			
Brick and mortar (1)	\$ 170.3		\$ 67.1



Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Residential:				
Home equity		<b>15.8</b>		14.3
First liens		<b>14.7</b>		15.7
Total	\$	<b>200.8</b>	\$	97.1

---

(1) The increase from December 31, 2010, was primarily due to certain loans that matured but were not paid off or extended during the three months ended March 31, 2011, for which resolution is pending and anticipated in the next quarter through either payoff, extension or foreclosure.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

The aging of mortgage loans and mortgage loans that were 90 days or more past due and still accruing interest were as follows:

	March 31, 2011						
	30-59 days past due	60-89 days past due	90 days or more past due	Total past due (in millions)	Current	Total loans	Recorded investment 90 days or more and accruing
Commercial-brick and mortar	\$ 65.0	\$ 28.6	\$	\$ 93.6	\$ 8,826.0	\$ 8,919.6	\$
Commercial-CTL					595.9	595.9	
Residential-home equity	8.0	4.6	8.9	21.5	667.4	688.9	
Residential-first liens	21.9	8.0	24.6	54.5	765.8	820.3	11.3
Total	\$ 94.9	\$ 41.2	\$ 33.5	\$ 169.6	\$ 10,855.1	\$ 11,024.7	\$ 11.3

	December 31, 2010						
	30-59 days past due	60-89 days past due	90 days or more past due	Total past due (in millions)	Current	Total loans	Recorded investment 90 days or more and accruing
Commercial-brick and mortar	\$	\$ 22.5	\$ 9.1	\$ 31.6	\$ 9,041.4	\$ 9,073.0	\$
Commercial-CTL					616.6	616.6	
Residential-home equity	9.3	4.5	9.2	23.0	696.3	719.3	
Residential-first liens	19.1	8.5	23.0	50.6	786.7	837.3	10.0
Total	\$ 28.4	\$ 35.5	\$ 41.3	\$ 105.2	\$ 11,141.0	\$ 11,246.2	\$ 10.0

**Mortgage Loan Valuation Allowance**

We establish a valuation allowance to provide for the risk of credit losses inherent in our portfolio. The valuation allowance includes loan specific reserves for loans that are deemed to be impaired as well as reserves for pools of loans with similar risk characteristics where a property risk or market specific risk has not been identified but for which we anticipate a loss may occur. Mortgage loans on real estate are considered impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to contractual terms of the loan agreement. When we determine that a loan is impaired, a valuation allowance is established equal to the difference between the carrying amount of the mortgage loan and the estimated value reduced by the cost to sell. Estimated value is based on either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or fair value of the collateral.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Subsequent changes in the estimated value are reflected in the valuation allowance. Amounts on loans deemed to be uncollectible are charged off and removed from the valuation allowance. The change in the valuation allowance provision and subsequent commercial mortgage loan recoveries is included in net realized capital gains (losses) on our consolidated statements of operations.

The valuation allowance is maintained at a level believed adequate by management to absorb estimated probable credit losses. Management's periodic evaluation and assessment of the valuation allowance adequacy is based on known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay, the estimated value of the underlying collateral, composition of the loan portfolio, portfolio delinquency information, underwriting standards, peer group information, current economic conditions, loss experience and other relevant factors. The evaluation of our impaired loan component is subjective, as it requires the estimation of timing and amount of future cash flows expected to be received on impaired loans.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)**

We review our commercial mortgage loan portfolio and analyze the need for a valuation allowance for any loan that is delinquent for 60 days or more, in process of foreclosure, restructured, on the internal watch list or that currently has a valuation allowance. In addition to establishing allowance levels for specifically identified impaired commercial mortgage loans, management determines an allowance for all other loans in the portfolio for which historical experience and current economic conditions indicate certain losses exist. These loans are segregated by major product type and/or risk level with an estimated loss ratio applied against each product type and/or risk level. The loss ratio is generally based upon historic loss experience for each loan type as adjusted for certain environmental factors management believes to be relevant.

For our residential mortgage loan portfolio, we separate the loans into several homogeneous pools, each of which consist of loans of a similar nature including but not limited to loans similar in collateral, term and structure and loan purpose or type. We evaluate loan pools based on aggregated risk ratings, estimated specific loss potential in the different classes of credits, and historical loss experience by pool type. We adjust these quantitative factors for qualitative factors of present conditions. Qualitative factors include items such as economic and business conditions, changes in the portfolio, value of underlying collateral, and concentrations. Residential mortgage loan pools exclude loans that have been restructured or impaired, as those loans are evaluated individually.

A rollforward of our valuation allowance and ending balances of the allowance and loan balance by basis of impairment method was as follows for the three months ended March 31, 2011:

	Commercial	Residential (in millions)	Total
Beginning balance	\$ 80.6	\$ 40.5	\$ 121.1
Provision	6.9	6.3	13.2
Charge-offs	(2.4)	(8.0)	(10.4)
Recoveries		0.9	0.9
Effect of exchange rates		(0.1)	(0.1)
Ending balance	\$ 85.1	\$ 39.6	\$ 124.7
Allowance ending balance by basis of impairment method:			
Individually evaluated for impairment	\$ 9.3	\$ 4.1	\$ 13.4
Collectively evaluated for impairment	75.8	35.5	111.3
Allowance ending balance	\$ 85.1	\$ 39.6	\$ 124.7
Loan balance by basis of impairment method:			
Individually evaluated for impairment	\$ 40.1	\$ 21.9	\$ 62.0
Collectively evaluated for impairment	9,475.4	1,487.3	10,962.7
Loan ending balance	\$ 9,515.5	\$ 1,509.2	\$ 11,024.7

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**3. Investments (continued)****Impaired Mortgage Loans**

Impaired mortgage loans are loans with a related specific valuation allowance, loans whose carrying amount has been reduced to the expected collectible amount because the impairment has been considered other than temporary or a loan modification has been classified as a TDR. Based on an assessment as to the collectability of the principal, a determination is made to apply any payments received either against the principal or according to the contractual terms of the loan. Our recorded investment in and unpaid principal balance of impaired loans along with the related loan specific allowance for losses, if any, as of March 31, 2011, and the average recorded investment and interest income recognized during the time the loans were impaired for the three months ended March 31, 2011, were as follows:

	Recorded investment	Unpaid principal balance	Related allowance (in millions)	Average recorded investment	Interest income recognized
With no related allowance recorded:					
Commercial-brick and mortar	\$ 23.9	\$ 27.3	\$	\$ 23.2	\$ 0.3
Residential-first liens	3.8	3.7		4.6	
With an allowance recorded:					
Commercial-brick and mortar	40.1	40.0	9.3	35.0	0.2
Residential-home equity	11.9	11.6	2.3	11.7	0.1
Residential-first liens	10.0	9.9	1.8	9.9	0.1
Total:					
Commercial	\$ 64.0	\$ 67.3	\$ 9.3	\$ 58.2	\$ 0.5
Residential	\$ 25.7	\$ 25.2	\$ 4.1	\$ 26.2	\$ 0.2

**Securities Posted as Collateral**

We posted \$1,059.1 million in fixed maturities, available-for-sale securities at March 31, 2011, to satisfy collateral requirements primarily associated with our derivative credit support annex (collateral) agreements and a reinsurance arrangement. In addition, we posted \$1,649.9 million in commercial mortgage loans as of March 31, 2011, to satisfy collateral requirements associated with our obligation under funding agreements with the Federal Home Loan Bank of Des Moines. Since we did not relinquish ownership rights on these securities, they are reported as fixed maturities, available-for-sale and commercial mortgage loans, respectively, on our consolidated statements of financial position.

**4. Derivative Financial Instruments**

Derivatives are generally used to hedge or reduce exposure to market risks associated with assets held or expected to be purchased or sold and liabilities incurred or expected to be incurred. Derivatives are used to change the characteristics of our asset/liability mix consistent with our risk management activities. Derivatives are also used in asset replication strategies.

## **Types of Derivative Instruments**

### ***Interest Rate Contracts***

Interest rate risk is the risk that we will incur economic losses due to adverse changes in interest rates. Sources of interest rate risk include the difference between the maturity and interest rate changes of assets with the liabilities they support, timing differences between the pricing of liabilities and the purchase or procurement of assets and changing cash flow profiles from original projections due to prepayment options embedded within asset and liability contracts. We use various derivatives to manage our exposure to fluctuations in interest rates.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

Interest rate swaps are contracts in which we agree with other parties to exchange, at specified intervals, the difference between fixed rate and floating rate interest amounts based upon designated market rates or rate indices and an agreed upon notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. Cash is paid or received based on the terms of the swap. These transactions are entered into pursuant to master agreements that provide for a single net payment to be made by one counterparty at each due date. We use interest rate swaps primarily to more closely match the interest rate characteristics of assets and liabilities and to mitigate the risks arising from timing mismatches between assets and liabilities (including duration mismatches). We also use interest rate swaps to hedge against changes in the value of assets we anticipate acquiring and other anticipated transactions and commitments. Interest rate swaps are used to hedge against changes in the value of the guaranteed minimum withdrawal benefit ( GMWB ) liability. The GMWB rider on our variable annuity products provides for guaranteed minimum withdrawal benefits regardless of the actual performance of various equity and/or fixed income funds available with the product.

Interest rate caps and interest rate floors, which can be combined to form interest rate collars, are contracts that entitle the purchaser to pay or receive the amounts, if any, by which a specified market rate exceeds a cap strike interest rate, or falls below a floor strike interest rate, respectively, at specified dates. We have entered into interest rate collars whereby we receive amounts if a specified market rate falls below a floor strike interest rate, and we pay if a specified market rate exceeds a cap strike interest rate. We use interest rate collars to manage interest rate risk related to guaranteed minimum interest rate liabilities in our individual annuities contracts.

A swaption is an option to enter into an interest rate swap at a future date. We purchase swaptions to offset existing exposures. Swaptions provide us the benefit of the agreed-upon strike rate if the market rates for liabilities are higher, with the flexibility to enter into the current market rate swap if the market rates for liabilities are lower. Swaptions not only hedge against the downside risk, but also allow us to take advantage of any upside benefits.

In exchange-traded futures transactions, we agree to purchase or sell a specified number of contracts, the values of which are determined by the values of designated classes of securities, and to post variation margin on a daily basis in an amount equal to the difference in the daily market values of those contracts. We enter into exchange-traded futures with regulated futures commissions merchants who are members of a trading exchange. We have used exchange-traded futures to reduce market risks from changes in interest rates and to alter mismatches between the assets in a portfolio and the liabilities supported by those assets.

***Foreign Exchange Contracts***

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from foreign currency-denominated funding agreements we issue, foreign currency-denominated fixed maturities we invest in and our

investment in and net income of our international operations. We may use currency swaps and currency forwards to hedge foreign currency risk.

Currency swaps are contracts in which we agree with other parties to exchange, at specified intervals, a series of principal and interest payments in one currency for that of another currency. Generally, the principal amount of each currency is exchanged at the beginning and termination of the currency swap by each party. The interest payments are primarily fixed-to-fixed rate; however, they may also be fixed-to-floating rate or floating-to-fixed rate. These transactions are entered into pursuant to master agreements that provide for a single net payment to be made by one counterparty for payments made in the same currency at each due date. We use currency swaps to reduce market risks from changes in currency exchange rates with respect to investments or liabilities denominated in foreign currencies that we either hold or intend to acquire or sell.

Currency forwards are contracts in which we agree with other parties to deliver a specified amount of an identified currency at a specified future date. Typically, the price is agreed upon at the time of the contract and payment for such a contract is made at the specified future date. We use currency forwards to reduce market risks from changes in currency exchange rates with respect to investments or liabilities denominated in foreign currencies that we either hold or intend to acquire or sell. We have also used currency forwards to hedge the currency risk associated with net investments in foreign operations. We did not use any currency forwards during 2011 or 2010 to hedge our net investment in foreign operations.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

*Equity Contracts*

Equity risk is the risk that we will incur economic losses due to adverse fluctuations in common stock. We use various derivatives to manage our exposure to equity risk, which arises from products in which the interest we credit is tied to an external equity index as well as products subject to minimum contractual guarantees.

We may sell an investment-type insurance contract with attributes tied to market indices (an embedded derivative as noted below), in which case we write an equity call option to convert the overall contract into a fixed-rate liability, essentially eliminating the equity component altogether. We purchase equity call spreads to hedge the equity participation rates promised to contractholders in conjunction with our fixed deferred annuity products that credit interest based on changes in an external equity index. We use exchange-traded futures and equity put options to hedge against changes in the value of the GMWB liability related to the GMWB rider on our variable annuity product, as previously explained. The premium associated with certain options is paid quarterly over the life of the option contract.

*Credit Contracts*

Credit risk relates to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest. We use credit default swaps to enhance the return on our investment portfolio by providing comparable exposure to fixed income securities that might not be available in the primary market. They are also used to hedge credit exposures in our investment portfolio. Credit derivatives are used to sell or buy credit protection on an identified name or names on an unfunded or synthetic basis in return for receiving or paying a quarterly premium. The premium generally corresponds to a referenced name's credit spread at the time the agreement is executed. In cases where we sell protection, at the same time we enter into these synthetic transactions, we buy a quality cash bond to match against the credit default swap. When selling protection, if there is an event of default by the referenced name, as defined by the agreement, we are obligated to pay the counterparty the referenced amount of the contract and receive in return the referenced security in a principal amount equal to the notional value of the credit default swap.

*Other Contracts*

*Embedded Derivatives.* We purchase or issue certain financial instruments or products that contain a derivative instrument that is embedded in the financial instrument or product. When it is determined that the embedded derivative possesses economic characteristics that are not clearly or

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

closely related to the economic characteristics of the host contract and a separate instrument with the same terms would qualify as a derivative instrument, the embedded derivative is bifurcated from the host instrument for measurement purposes. The embedded derivative, which is reported with the host instrument in the consolidated statements of financial position, is carried at fair value.

We sell investment-type insurance contracts in which the return is tied to an external equity index, a leveraged inflation index or leveraged reference swap. We economically hedge the risk associated with these investment-type insurance contracts.

We offer group benefit plan contracts that have guaranteed separate accounts as an investment option. We also offer a guaranteed fund as an investment option in our defined contribution plans in Hong Kong.

We have structured investment relationships with trusts we have determined to be VIEs, which are consolidated in our financial statements. The notes issued by these trusts include obligations to deliver an underlying security to residual interest holders and the obligations contain an embedded derivative of the forecasted transaction to deliver the underlying security.

We have fixed deferred annuities that credit interest based on changes in an external equity index. We also have certain variable annuity products with a GMWB rider, which provides that the contractholder will receive at least their principal deposit back through withdrawals of up to a specified annual amount, even if the account value is reduced to zero. Declines in the equity market may increase our exposure to benefits under contracts with the GMWB. We economically hedge the exposure in these annuity contracts, as previously explained.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

**Exposure**

Our risk of loss is typically limited to the fair value of our derivative instruments and not to the notional or contractual amounts of these derivatives. Risk arises from changes in the fair value of the underlying instruments. We are also exposed to credit losses in the event of nonperformance of the counterparties. Our current credit exposure is limited to the value of derivatives that have become favorable to us. This credit risk is minimized by purchasing such agreements from financial institutions with high credit ratings and by establishing and monitoring exposure limits. We also utilize various credit enhancements, including collateral and credit triggers to reduce the credit exposure to our derivative instruments.

Our derivative transactions are generally documented under International Swaps and Derivatives Association, Inc. ( ISDA ) Master Agreements. Management believes that such agreements provide for legally enforceable set-off and close-out netting of exposures to specific counterparties. Under such agreements, in connection with an early termination of a transaction, we are permitted to set off our receivable from a counterparty against our payables to the same counterparty arising out of all included transactions. For reporting purposes, we do not offset fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against fair value amounts recognized for derivative instruments executed with the same counterparties under master netting agreements.

We posted \$320.5 million and \$376.8 million in cash and securities under collateral arrangements as of March 31, 2011 and December 31, 2010, respectively, to satisfy collateral requirements associated with our derivative credit support agreements.

Certain of our derivative instruments contain provisions that require us to maintain an investment grade rating from each of the major credit rating agencies on our debt. If the rating on our debt were to fall below investment grade, it would be in violation of these provisions and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value, inclusive of accrued interest, of all derivative instruments with credit-risk-related contingent features that were in a liability position without regard to netting under derivative credit support annex agreements as of March 31, 2011 and December 31, 2010, was \$1,150.0 million and \$1,262.0 million, respectively. With respect to these derivatives, we posted collateral of \$320.5 million and \$376.8 million as of March 31, 2011 and December 31, 2010, respectively, in the normal course of business, which reflects netting under derivative credit support annex agreements. If the credit-risk-related contingent features underlying these agreements were triggered on March 31, 2011, we would be required to post an additional \$41.2 million of collateral to our counterparties.

As of March 31, 2011 and December 31, 2010, we had received \$253.3 million and \$249.2 million, respectively, of cash collateral associated with our derivative credit support annex agreements. The cash collateral is included in other assets on the consolidated statements of financial position, with a corresponding liability reflecting our obligation to return the collateral recorded in other liabilities.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

Notional amounts are used to express the extent of our involvement in derivative transactions and represent a standard measurement of the volume of our derivative activity. Notional amounts represent those amounts used to calculate contractual flows to be exchanged and are not paid or received, except for contracts such as currency swaps. Credit exposure represents the gross amount owed to us under derivative contracts as of the valuation date. The notional amounts and credit exposure of our derivative financial instruments by type were as follows:

	March 31, 2011	December 31, 2010
	(in millions)	
<b>Notional amounts of derivative instruments</b>		
<i>Interest rate contracts:</i>		
Interest rate swaps	\$ 20,050.6	\$ 19,803.0
Interest rate collars	500.0	500.0
Swaptions	68.5	68.5
Futures	336.3	0.8
<i>Foreign exchange contracts:</i>		
Foreign currency swaps	4,366.4	4,615.2
Currency forwards	70.1	72.3
<i>Equity contracts:</i>		
Options	1,046.1	997.5
Futures	124.1	
<i>Credit contracts:</i>		
Credit default swaps	1,521.1	1,482.4
<i>Other contracts:</i>		
Embedded derivative financial instruments	4,117.4	3,991.6
Total notional amounts at end of period	\$ 32,200.6	\$ 31,531.3
<b>Credit exposure of derivative instruments</b>		
<i>Interest rate contracts:</i>		
Interest rate swaps	\$ 546.2	\$ 607.1
Interest rate collars	1.1	1.7
Swaptions		0.1
<i>Foreign exchange contracts:</i>		
Foreign currency swaps	508.3	493.2
Currency forwards	1.0	3.3
<i>Equity contracts:</i>		
Options	58.1	64.9
<i>Credit contracts:</i>		
Credit default swaps	5.6	6.7
Total gross credit exposure	1,120.3	1,177.0
Less: collateral received	253.3	249.2
Net credit exposure	\$ 867.0	\$ 927.8



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

The fair value of our derivative instruments classified as assets and liabilities was as follows:

	Derivative assets (1)		Derivative liabilities (2)	
	March 31, 2011	December 31, 2010	March 31, 2011	December 31, 2010
(in millions)				
<b>Derivatives designated as hedging instruments</b>				
Interest rate contracts	\$ 58.2	\$ 66.6	\$ 390.4	\$ 405.4
Foreign exchange contracts	420.2	390.8	164.1	142.5
Total derivatives designated as hedging instruments	\$ 478.4	\$ 457.4	\$ 554.5	\$ 547.9
<b>Derivatives not designated as hedging instruments</b>				
Interest rate contracts	\$ 425.4	\$ 488.4	\$ 389.6	\$ 459.5
Foreign exchange contracts	70.7	65.8	38.1	60.4
Equity contracts	58.1	64.9	42.3	31.7
Credit contracts	5.6	6.7	180.3	171.7
Other contracts			148.2	145.7
Total derivatives not designated as hedging instruments	\$ 559.8	\$ 625.8	\$ 798.5	\$ 869.0
Total derivative instruments	\$ 1,038.2	\$ 1,083.2	\$ 1,353.0	\$ 1,416.9

(1) The fair value of derivative assets is reported with other investments on the consolidated statements of financial position.

(2) The fair value of derivative liabilities is reported with other liabilities on the consolidated statements of financial position, with the exception of certain embedded derivative liabilities. Embedded derivative liabilities with a fair value of \$4.2 million and \$6.6 million as of March 31, 2011 and December 31, 2010, respectively, are reported with contractholder funds on the consolidated statements of financial position.

**Credit Derivatives Sold**

When we sell credit protection, we are exposed to the underlying credit risk similar to purchasing a fixed maturity security instrument. The majority of our credit derivative contracts sold reference a single name or reference security (referred to as single name credit default swaps ).

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

The remainder of our credit derivatives reference either a basket or index of securities. These instruments are either referenced in an over-the-counter credit derivative transaction, or embedded within an investment structure that has been fully consolidated into our financial statements.

These credit derivative transactions are subject to events of default defined within the terms of the contract, which normally consist of bankruptcy, failure to pay, or modified restructuring of the reference entity and/or issue. If a default event occurs for a reference name or security, we are obligated to pay the counterparty an amount equal to the notional amount of the credit derivative transaction. As a result, our maximum future payment is equal to the notional amount of the credit derivative. In certain cases, we also have purchased credit protection with identical underlyings to certain of our sold protection transactions. The effect of this purchased protection would reduce our total maximum future payments by \$10.0 million as of both March 31, 2011 and December 31, 2010. These credit derivative transactions had a net liability fair value of \$0.9 million and \$0.8 million as of March 31, 2011 and December 31, 2010, respectively. Our potential loss could also be reduced by any amount recovered in the default proceedings of the underlying credit name.

We purchased certain investment structures with embedded credit features that are fully consolidated into our financial statements. This consolidation results in recognition of the underlying credit derivatives and collateral within the structure, typically high quality fixed maturities that are owned by a special purpose vehicle. These credit derivatives reference a single name or several names in a basket structure. In the event of default, the collateral within the structure would typically be liquidated to pay the claims of the credit derivative counterparty.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

The following tables show our credit default swap protection sold by types of contract, types of referenced/underlying asset class and external agency rating for the underlying reference security. The maximum future payments are undiscounted and have not been reduced by the effect of any offsetting transactions, collateral or recourse features described above.

	March 31, 2011			Weighted average expected life (in years)
	Notional amount	Fair value (in millions)	Maximum future payments	
<b>Single name credit default swaps</b>				
Corporate debt				
AA	\$ 125.0	\$ (0.2)	\$ 125.0	3.8
A	564.0	1.1	564.0	2.6
BBB	120.0	0.4	120.0	1.1
Structured finance				
B	9.9	(6.4)	9.9	1.3
CCC	32.0	(27.1)	32.0	9.7
Near default	4.7	(4.2)	4.7	4.2
Total single name credit default swaps	855.6	(36.4)	855.6	2.8
<b>Basket and index credit default swaps</b>				
Corporate debt				
A	6.0		6.0	0.7
CCC	135.0	(115.3)	135.0	6.0
CC	15.0	(6.8)	15.0	1.7
Government/municipalities				
A	40.0	(9.7)	40.0	5.1
Structured finance				
AA	20.0	(2.1)	20.0	4.2
BBB	5.0	(0.3)	5.0	14.7
Total basket and index credit default swaps	221.0	(134.2)	221.0	5.4
Total credit default swap protection sold	\$ 1,076.6	\$ (170.6)	\$ 1,076.6	3.4

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

	December 31, 2010			Weighted average expected life (in years)
	Notional amount	Fair value (in millions)	Maximum future payments	
<b>Single name credit default swaps</b>				
Corporate debt				
AA	\$ 135.0	\$ (0.5)	\$ 135.0	3.9
A	564.0	0.9	564.0	2.9
BBB	150.0	0.3	150.0	1.1
Structured finance				
B	25.9	(20.0)	25.9	5.9
CCC	22.0	(18.4)	22.0	9.4
Total single name credit default swaps	896.9	(37.7)	896.9	3.0
<b>Basket and index credit default swaps</b>				
Corporate debt				
A	6.0		6.0	1.0
CCC	125.0	(103.0)	125.0	6.2
CC	15.0	(8.5)	15.0	2.0
Government/municipalities				
A	40.0	(11.2)	40.0	5.4
Structured finance				
AA	20.0	(2.0)	20.0	4.4
BBB	5.0	(0.3)	5.0	14.9
Total basket and index credit default swaps	211.0	(125.0)	211.0	5.6
Total credit default swap protection sold	\$ 1,107.9	\$ (162.7)	\$ 1,107.9	3.5

We also have invested in fixed maturities classified as available-for-sale that contain credit default swaps that do not require bifurcation and fixed maturities classified as trading that contain credit default swaps. These securities are subject to the credit risk of the issuer, normally a special purpose vehicle, which consists of the underlying credit default swaps and high quality fixed maturities that serve as collateral. A default event occurs if the cumulative losses exceed a specified attachment point, which is typically not the first loss of the portfolio. If a default event occurs that exceeds the specified attachment point, our investment may not be fully returned. We would have no future potential payments under these investments. The following tables show, by the types of referenced/underlying asset class and external rating, our fixed maturities with embedded credit derivatives.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

	March 31, 2011		Weighted average expected life (in years)
	Amortized cost	Carrying value	
	(in millions)		
<b>Corporate debt</b>			
BB	\$ 16.9	\$ 16.9	5.7
CCC	50.0	47.3	1.9
CC	12.1	3.7	4.7
Total corporate debt	79.0	67.9	3.1
<b>Structured finance</b>			
AA	4.5	4.5	8.1
BBB	27.1	23.6	5.3
BB	15.5	15.2	3.5
B	11.2	11.2	6.2
CCC	8.5	8.0	5.6
C	1.6	2.3	6.5
Total structured finance	68.4	64.8	5.3
Total fixed maturities with credit derivatives	\$ 147.4	\$ 132.7	4.1

	December 31, 2010		Weighted average expected life (in years)
	Amortized cost	Carrying value	
	(in millions)		
<b>Corporate debt</b>			
BB	\$ 18.1	\$ 18.1	6.0
CCC	50.0	46.2	2.1
CC	12.1	1.6	4.9
Total corporate debt	80.2	65.9	3.4
<b>Structured finance</b>			
AA	5.2	5.2	5.8
BBB	26.8	23.1	5.5
BB	15.5	15.0	3.7
B	10.5	10.5	6.4
CCC	9.2	8.7	5.9
C	13.5	5.8	12.8
Total structured finance	80.7	68.3	6.6
Total fixed maturities with credit derivatives	\$ 160.9	\$ 134.2	5.0

**Fair Value Hedges**

We use fixed-to-floating rate interest rate swaps to more closely align the interest rate characteristics of certain assets and liabilities. In general, these swaps are used in asset and liability management to modify duration, which is a measure of sensitivity to interest rate changes.

We enter into currency exchange swap agreements to convert certain foreign denominated assets and liabilities into U.S. dollar floating-rate denominated instruments to eliminate the exposure to future currency volatility on those items.

We also sell callable investment-type insurance contracts and use cancellable interest rate swaps to hedge the changes in fair value of the callable feature.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

The net interest effect of interest rate swap and currency swap transactions for derivatives in fair value hedges is recorded as an adjustment to income or expense of the underlying hedged item in our consolidated statements of operations.

Hedge effectiveness testing for fair value relationships is performed utilizing a regression analysis approach for both prospective and retrospective evaluations. This regression analysis will consider multiple data points for the assessment that the hedge continues to be highly effective in achieving offsetting changes in fair value. In certain periods, the comparison of the change in value of the derivative and the change in the value of the hedged item may not be offsetting at a specific period in time due to small movements in value. However, any amounts recorded as fair value hedges have shown to be highly effective in achieving offsetting changes in fair value both for present and future periods.

The following table shows the effect of derivatives in fair value hedging relationships and the related hedged items on the consolidated statements of operations. All gains or losses on derivatives were included in the assessment of hedge effectiveness.

Derivatives in fair value hedging relationships	Amount of gain (loss) recognized in net income on derivatives for the three months ended			Hedged items in fair value hedging relationships	Amount of gain (loss) recognized in net income on related hedged item for the three months ended				
	March 31, (1)		2010		March 31, (1)		2010		
	2011	(in millions)			2011	(in millions)			
Interest rate contracts	\$	39.7	\$	(36.5)	Fixed maturities, available-for-sale	\$	(38.0)	\$	36.1
Interest rate contracts		(1.0)		6.5	Investment-type insurance contracts		1.4		(6.1)
Foreign exchange contracts		(1.7)		4.6	Fixed maturities, available-for-sale		2.0		(4.0)
Foreign exchange contracts		7.3		(38.4)	Investment-type insurance contracts		(8.2)		37.7
Total	\$	44.3	\$	(63.8)	Total	\$	(42.8)	\$	63.7

(1) The gain (loss) on both derivatives and hedged items in fair value relationships is reported in net realized capital gains (losses) on the consolidated statements of operations. The net amount represents the ineffective portion of our fair value hedges.

The following table shows the periodic settlements on interest rate contracts and foreign exchange contracts in fair value hedging relationships.

Hedged item	Amount of gain (loss) for the three months ended		
	2011	March 31,	2010
		(in millions)	
Fixed maturities, available-for-sale (1)	\$	(39.8)	\$ (41.9)
Investment-type insurance contracts (2)		11.5	21.5

---

(1) Reported in net investment income on the consolidated statements of operations.

(2) Reported in benefits, claims and settlement expenses on the consolidated statements of operations.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)****Cash Flow Hedges**

We utilize floating-to-fixed rate interest rate swaps to eliminate the variability in cash flows of recognized financial assets and liabilities and forecasted transactions.

We enter into currency exchange swap agreements to convert both principal and interest payments of certain foreign denominated assets and liabilities into U.S. dollar denominated fixed-rate instruments to eliminate the exposure to future currency volatility on those items.

The net interest effect of interest rate swap and currency swap transactions for derivatives in cash flow hedges is recorded as an adjustment to income or expense of the underlying hedged item in our consolidated statements of operations.

The maximum length of time that we are hedging our exposure to the variability in future cash flows for forecasted transactions, excluding those related to the payments of variable interest on existing financial assets and liabilities, is 9.2 years. At March 31, 2011, we had \$58.1 million of gross unrealized gains reported in AOCI on the consolidated statements of financial position related to active hedges of forecasted transactions. If a hedged forecasted transaction is no longer probable of occurring, cash flow hedge accounting is discontinued. If it is probable that the hedged forecasted transaction will not occur, the deferred gain or loss is immediately reclassified from OCI into net income. During the three months ended March 31, 2011 and 2010, there were no gross unrealized gains or losses reclassified from AOCI into net realized capital gains (losses) as a result of the determination that hedged cash flows of a forecasted liability issuance were probable of not occurring.

The following table shows the effect of derivatives in cash flow hedging relationships on the consolidated statements of operations and consolidated statements of financial position. All gains or losses on derivatives were included in the assessment of hedge effectiveness.

Derivatives in cash flow hedging relationships	Related hedged item	Amount of gain (loss) recognized in AOCI on derivatives (effective portion) for the three months ended March 31,		Location of gain (loss) reclassified from AOCI into net income (effective portion)	Amount of gain (loss) reclassified from AOCI on derivatives (effective portion) for the three months ended March 31,			
		2011	2010		2011	2010		
		(in millions)				(in millions)		
Interest rate contracts	\$	4.4	\$	(6.4) Net investment income	\$	1.8	\$	1.7

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

	Fixed maturities, available-for-sale						
Interest rate contracts	Investment-type insurance contracts	(4.7)	2.6	Benefits, claims and settlement expenses	(0.3)	(0.3)	
Interest rate contracts	Debt			Operating expense	(1.3)	(1.1)	
Foreign exchange contracts	Fixed maturities, available-for-sale	(42.8)	94.0	Net investment income			
Foreign exchange contracts	Investment-type insurance contracts	45.0	(75.6)	Benefits, claims and settlement expenses	(1.5)	(1.5)	
				Net realized capital gains (losses)	3.3		
Total		\$ 1.9	\$ 14.6	Total	\$ 2.0	\$ (1.2)	



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**4. Derivative Financial Instruments (continued)**

The following table shows the periodic settlements on interest rate contracts and foreign exchange contracts in cash flow hedging relationships.

Hedged item	Amount of gain (loss) for the three months ended		
	2011	March 31,	2010
		(in millions)	
Fixed maturities, available-for-sale (1)	\$	3.0	\$ 4.0
Investment-type insurance contracts (2)		(2.6)	(4.0)

(1) Reported in net investment income on the consolidated statements of operations.

(2) Reported in benefits, claims and settlement expenses on the consolidated statements of operations.

The ineffective portion of our cash flow hedges is reported in net realized capital gains (losses) on the consolidated statements of operations. The net gain resulting from the ineffective portion of foreign currency contracts in cash flow hedging relationships was \$0.1 million and \$0.4 million for the three months ended March 31, 2011 and 2010, respectively.

We expect to reclassify net gains of \$22.1 million from AOCI into net income in the next 12 months, which includes both net deferred gains on discontinued hedges and net deferred losses on periodic settlements of active hedges. Actual amounts may vary from this amount as a result of market conditions.

**Derivatives Not Designated as Hedging Instruments**

Our use of futures, certain swaptions and swaps, collars, options and forwards are effective from an economic standpoint, but they have not been designated as hedges for financial reporting purposes. As such, periodic changes in the market value of these instruments, which includes mark-to-market gains and losses as well as periodic and final settlements, primarily flow directly into net realized capital gains (losses) on the consolidated statements of operations. Gains and losses on certain derivatives used in relation to certain trading portfolios are reported in net investment income on the consolidated statements of operations.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

The following tables show the effect of derivatives not designated as hedging instruments, including market value changes of embedded derivatives that have been bifurcated from the host contract, on the consolidated statements of operations.

Derivatives not designated as hedging instruments	Amount of gain (loss) recognized in net income on derivatives for the three months ended March 31,	
	2011	2010
	(in millions)	
Interest rate contracts	\$ 4.3	\$ 23.1
Foreign exchange contracts	19.0	(21.6)
Equity contracts	(22.6)	(14.7)
Credit contracts	(2.4)	1.9
Other contracts	(5.0)	7.9
Total	\$ (6.7)	\$ (3.4)

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**5. Income Taxes**

The effective income tax rate for the three months ended March 31, 2011, was lower than the U.S. corporate income tax rate of 35% ( U.S. statutory rate ) primarily due to income tax deductions allowed for corporate dividends received, taxes on our share of earnings generated from equity method investments reflected in net investment income and the inclusion of income attributable to noncontrolling interest in income before income taxes with no corresponding change in income taxes reported by us as the controlling interest.

The effective income tax rate for the three months ended March 31, 2010, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received and taxes on our share of earnings generated from equity method investments reflected in net investment income.

The Internal Revenue Service ( IRS ) has completed examination of our consolidated federal income tax returns for years prior to 2004. The IRS commenced examination of the U.S. consolidated federal income tax returns for 2004-2005 in March 2007, for 2006-2007 in March 2009 and for the 2008 tax return in January 2010. The fieldwork is complete and the final reports were received in the second quarter of 2011. We do not expect the ultimate settlement of these audits or developments in other tax areas to significantly change the possible increase in the amount of unrecognized tax benefits, but the outcome of tax reviews is uncertain and unforeseen results can occur. Consistent with December 31, 2010, we do not believe there is a reasonable possibility that the total amount of our unrecognized tax benefits will significantly increase or decrease in the next twelve months.

**6. Employee and Agent Benefits****Components of Net Periodic Benefit Cost**

	Pension benefits			Other postretirement benefits		
	For the three months ended			For the three months ended		
	March 31,			March 31,		
	2011	2010		2011	2010	
	(in millions)					
Service cost	\$ 10.9	\$ 11.4	\$	0.3	\$	2.8
Interest cost	26.8	26.4		2.2		5.3
Expected return on plan assets	(28.2)	(24.6)		(8.5)		(7.5)
Amortization of prior service benefit	(2.5)	(2.5)		(7.4)		(0.5)
Recognized net actuarial loss	15.7	16.9		0.1		1.2

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Amounts recognized due to special events		(0.3)				(1.2)	
Net periodic benefit cost (income)	\$	22.4	\$	27.6	\$	(14.5)	\$ 1.3

**Impact from Exit of Group Medical Insurance Business**

Our September 30, 2010, announcement to exit the group medical insurance business resulted in a curtailment associated with the pension and other postretirement benefits of the impacted employees. We have determined that the curtailment will result in a gain, which will be recognized quarterly in our consolidated financial statements as impacted employees are terminated. In the first quarter of 2011, the curtailment gain recognized was \$0.3 million for the pension benefits and \$1.2 million for the other postretirement benefits from the accelerated recognition of the existing prior service benefits.

**Contributions**

Our funding policy for our qualified pension plan is to fund the plan annually in an amount at least equal to the minimum annual contribution required under the Employee Retirement Income Security Act ( ERISA ) and, generally, not greater than the maximum amount that can be deducted for federal income tax purposes. The minimum annual contribution for 2011 will be zero so we will not be required to fund our qualified pension plan during 2011. However, it is possible that we may fund the qualified and nonqualified pension plans in 2011 for a combined total of \$60.0 million to \$90.0 million. During the three months ended March 31, 2011, we contributed \$16.2 million to these plans.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**7. Contingencies, Guarantees and Indemnifications**

**Litigation and Regulatory Contingencies**

We are regularly involved in litigation, both as a defendant and as a plaintiff, but primarily as a defendant. Litigation naming us as a defendant ordinarily arises out of our business operations as a provider of asset management and accumulation products and services, life, health and disability insurance. Some of the lawsuits are class actions, or purport to be, and some include claims for unspecified or substantial punitive and treble damages. In addition, regulatory bodies such as state insurance departments, the SEC, the Financial Industry Regulatory Authority, the Department of Labor and other regulatory agencies regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, ERISA and laws governing the activities of broker-dealers. We receive requests from regulators and other governmental authorities relating to industry issues and may receive additional requests, including subpoenas and interrogatories, in the future.

On November 8, 2006, a trustee of Fairmount Park Inc. Retirement Savings Plan filed a putative class action lawsuit in the United States District Court for the Southern District of Illinois against Principal Life. Principal Life's motion to transfer venue was granted and the case is now pending in the Southern District of Iowa. The complaint alleged, among other things, that Principal Life breached its alleged fiduciary duties while performing services to 401(k) plans by failing to disclose, or adequately disclose, to employers or plan participants the fact that Principal Life receives revenue sharing fees from mutual funds that are included in its pre-packaged 401(k) plans and allegedly failed to use the revenue to defray the expenses of the services provided to the plans. Plaintiff further alleged that these acts constitute prohibited transactions under ERISA. Plaintiff sought to certify a class of all retirement plans to which Principal Life was a service provider and for which Principal Life received and retained revenue sharing fees from mutual funds. On August 27, 2008, the plaintiff's motion for class certification was denied. The plaintiff's new motion for class certification, filed May 11, 2009, was stricken by the court on March 31, 2010. Principal Life continues to aggressively defend the lawsuit.

On October 28, 2009, Judith Curran filed a derivative action lawsuit on behalf of Principal Funds, Inc. Strategic Asset Management Portfolios in the United States District Court for the Southern District of Iowa against Principal Management Corporation, Principal Global Investors, LLC, and Principal Funds Distributor, Inc. (the Curran Defendants). The lawsuit alleges the Curran Defendants breached their fiduciary duty under Section 36(b) of the Investment Company Act by charging advisory fees and distribution fees that were excessive. The Curran Defendants filed a motion to dismiss the case on January 29, 2010. That motion was granted in part and overruled in part. Principal Global Investors, LLC was dismissed from the suit. The remaining Curran Defendants are aggressively defending the lawsuit.

On December 2, 2009 and December 4, 2009, two plaintiffs, Cruise and Mullaney, each filed putative class action lawsuits in the United States District Court for the Southern District of New York against us, Principal Life, Principal Global Investors, LLC, and Principal Real Estate Investors, LLC (the Cruise/Mullaney Defendants). The lawsuits alleged the Cruise/Mullaney Defendants failed to manage the Principal U.S. Property Separate Account ( PUSPSA ) in the best interests of investors, improperly imposed a withdrawal freeze on September 26, 2008, and instituted a withdrawal queue to honor withdrawal requests as sufficient liquidity became available. Plaintiffs allege these actions constitute a breach of fiduciary duties under ERISA. Plaintiffs seek to certify a class including all qualified ERISA plans and the participants of those plans

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

that invested in PUSPSA between September 26, 2008, and the present that have suffered losses caused by the queue. The two lawsuits, as well as two subsequently filed complaints asserting similar claims, have been consolidated and are now known as *In re Principal U.S. Property Account Litigation*. On April 22, 2010, an order was entered granting the motion made by the Cruise/Mullaney Defendants for change of venue to the United States District Court for the Southern District of Iowa. The plaintiffs have filed a Consolidated Complaint adding five new plaintiffs. The Cruise/Mullaney Defendants are aggressively defending the lawsuit.

While the outcome of any pending or future litigation or regulatory matter cannot be predicted, management does not believe that any pending litigation or regulatory matter will have a material adverse effect on our business or financial position. The outcome of such matters is always uncertain, and unforeseen results can occur. It is possible that such outcomes could materially affect net income in a particular quarter or annual period.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**7. Contingencies, Guarantees and Indemnifications (continued)****Guarantees and Indemnifications**

In the normal course of business, we have provided guarantees to third parties primarily related to a former subsidiary and joint ventures. These agreements generally expire through 2019. The maximum exposure under these agreements as of March 31, 2011, was approximately \$216.0 million. At inception, the fair value of such guarantees was insignificant. In addition, we believe the likelihood is remote that material payments will be required. Therefore, any liability accrued within our consolidated statements of financial position is insignificant. Should we be required to perform under these guarantees, we generally could recover a portion of the loss from third parties through recourse provisions included in agreements with such parties, the sale of assets held as collateral that can be liquidated in the event that performance is required under the guarantees or other recourse generally available to us; therefore, such guarantees would not result in a material adverse effect on our business or financial position. While the likelihood is remote, such outcomes could materially affect net income in a particular quarter or annual period.

We are also subject to various other indemnification obligations issued in conjunction with divestitures, acquisitions and financing transactions whose terms range in duration and often are not explicitly defined. Certain portions of these indemnifications may be capped, while other portions are not subject to such limitations; therefore, the overall maximum amount of the obligation under the indemnifications cannot be reasonably estimated. At inception, the fair value of such indemnifications was insignificant. In addition, we believe the likelihood is remote that material payments will be required. Therefore, any liability accrued within our consolidated statements of financial position is insignificant. While we are unable to estimate with certainty the ultimate legal and financial liability with respect to these indemnifications, we believe that performance under these indemnifications would not result in a material adverse effect on our business or financial position. While the likelihood is remote, performance under these indemnifications could materially affect net income in a particular quarter or annual period.

**8. Stockholders Equity****Reconciliation of Outstanding Shares**

	Series A preferred stock	Series B preferred stock (in millions)	Common stock
Outstanding shares at January 1, 2010	3.0	10.0	319.0
Shares issued			0.8
Treasury stock acquired			(0.1)
Outstanding shares at March 31, 2010	3.0	10.0	319.7

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Outstanding shares at January 1, 2011	3.0	10.0	320.4
Shares issued			1.1
Treasury stock acquired			(0.2)
Outstanding shares at March 31, 2011	3.0	10.0	321.3



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**8. Stockholders Equity (continued)****Comprehensive Income**

	For the three months ended	
	2011	March 31, 2010
	(in millions)	
Net income	\$ 223.1	\$ 203.6
Net change in unrealized gains on fixed maturities, available-for-sale	265.9	962.6
Net change in noncredit component of impairment losses on fixed maturities, available-for-sale (1)	38.4	(5.4)
Net change in unrealized gains on equity securities, available-for-sale	11.9	1.3
Net change in unrealized gains (losses) on equity method subsidiaries and noncontrolling interest adjustments	3.1	(24.1)
Adjustments for assumed changes in amortization patterns	(63.9)	(203.5)
Adjustments for assumed changes in policyholder liabilities	25.7	(43.4)
Net change in unrealized gains (losses) on derivative instruments	(8.6)	1.1
Change in net foreign currency translation adjustment	27.8	(5.8)
Change in unrecognized postretirement benefit obligation	75.7	15.2
Provision for deferred income taxes	(122.9)	(244.4)
Comprehensive income	\$ 476.2	\$ 657.2

(1) Represents the net impact of (1) unrealized gains resulting from reclassification of previously recognized noncredit impairment losses from OCI to net realized capital gains (losses) for fixed maturities with bifurcated OTTI that had additional credit losses or fixed maturities that previously had bifurcated OTTI that have now been sold or are intended to be sold and (2) unrealized losses resulting from reclassification of noncredit impairment losses for fixed maturities with bifurcated OTTI from net realized capital gains (losses) to OCI.

**9. Fair Value Measurements**

We use fair value measurements to record fair value of certain assets and liabilities and to estimate fair value of financial instruments not recorded at fair value but required to be disclosed at fair value. Certain financial instruments, particularly policyholder liabilities other than investment-type insurance contracts, are excluded from these fair value disclosure requirements.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)****Fair Value of Financial Instruments**

The carrying value and estimated fair value of financial instruments were as follows:

	March 31, 2011		December 31, 2010	
	Carrying amount	Fair value	Carrying amount	Fair value
	(in millions)			
<b>Assets (liabilities)</b>				
Fixed maturities, available-for-sale	\$ 48,305.5	\$ 48,305.5	\$ 48,636.3	\$ 48,636.3
Fixed maturities, trading	1,006.3	1,006.3	1,120.3	1,120.3
Equity securities, available-for-sale	175.8	175.8	169.9	169.9
Equity securities, trading	389.7	389.7	316.9	316.9
Mortgage loans	10,900.0	11,090.2	11,125.1	11,197.8
Policy loans	893.0	980.8	903.9	1,012.1
Other investments	315.5	315.5	311.3	311.3
Cash and cash equivalents	1,984.2	1,984.2	1,877.4	1,877.4
Derivative assets	1,038.2	1,038.2	1,083.2	1,083.2
Separate account assets	71,724.5	71,724.5	69,555.3	69,555.3
Cash collateral	255.3	255.3	236.0	236.0
Investment-type insurance contracts	(31,891.5)	(32,002.1)	(32,720.1)	(32,828.6)
Short-term debt	(106.8)	(106.8)	(107.9)	(107.9)
Long-term debt	(1,579.8)	(1,765.5)	(1,583.7)	(1,756.3)
Separate account liabilities	(64,359.9)	(63,324.7)	(62,681.4)	(61,594.1)
Derivative liabilities	(1,208.6)	(1,208.6)	(1,274.5)	(1,274.5)
Bank deposits	(2,191.1)	(2,201.3)	(2,219.2)	(2,230.9)
Cash collateral payable	(253.3)	(253.3)	(236.0)	(236.0)
Other liabilities	(246.6)	(246.6)	(250.3)	(250.3)

**Valuation Hierarchy**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three levels.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

- **Level 1** Fair values are based on unadjusted quoted prices in active markets for identical assets or liabilities. Our Level 1 assets and liabilities primarily include exchange traded equity securities, mutual funds and U.S. Treasury bonds.
- **Level 2** Fair values are based on inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. Our Level 2 assets and liabilities primarily include fixed maturities (including public and private bonds), equity securities, over-the-counter derivatives and other investments for which public quotations are not available but that are priced by third-party pricing services or internal models using substantially all observable inputs.
- **Level 3** Fair values are based on significant unobservable inputs for the asset or liability. Our Level 3 assets and liabilities include certain fixed maturities, private equity securities, real estate and commercial mortgage loan investments of our separate accounts, commercial mortgage loan investments and obligations of consolidated VIEs for which the fair value option was elected, complex derivatives and embedded derivatives that must be priced using broker quotes or other valuation methods that utilize at least one significant unobservable input.

### Determination of Fair Value

The following discussion describes the valuation methodologies and inputs used for assets and liabilities measured at fair value on a recurring basis or disclosed at fair value. The techniques utilized in estimating the fair values of financial instruments are reliant on the assumptions used. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument. We validate prices through an investment analyst review process, which includes validation through direct interaction with external sources, review of recent trade activity or use of internal models. In circumstances where broker quotes are used to value an instrument, we generally receive one non-binding quote. Broker quotes are validated through an investment analyst review process, which includes validation through direct interaction with external sources and use of internal models or other relevant information. We did not make any significant changes to our valuation processes during 2011.

***Fixed Maturities***

Fixed maturities include bonds, ABS, redeemable preferred stock and certain nonredeemable preferred stock. When available, the fair value of fixed maturities is based on quoted prices of identical assets in active markets. These are reflected in Level 1 and primarily include U.S. Treasury bonds and actively traded redeemable corporate preferred securities.

When quoted prices are not available, our first priority is to obtain prices from third party pricing vendors. We have regular interaction with these vendors to ensure we understand their pricing methodologies and to confirm they are utilizing observable market information. Their methodologies vary by asset class and include inputs such as estimated cash flows, benchmark yields, reported trades, broker quotes, credit quality, industry events and economic events. Fixed maturities with validated prices from pricing services, which includes the majority of our public fixed maturities in all asset classes, are generally reflected in Level 2. Also included in Level 2 are corporate bonds where quoted market prices are not available, for which a matrix pricing valuation approach is used. In this approach, securities are grouped into pricing categories that vary by sector, rating and average life. Each pricing category is assigned a risk spread based on studies of observable public market data from the investment professionals assigned to specific security classes. The expected cash flows of the security are then discounted back at the current Treasury curve plus the appropriate risk spread. Although the matrix valuation approach provides a fair valuation of each pricing category, the valuation of an individual security within each pricing category may actually be impacted by company specific factors.

If we are unable to price a fixed maturity security using prices from third party pricing vendors or other sources specific to the asset class, we may obtain a broker quote or utilize an internal pricing model specific to the asset utilizing relevant market information, to the extent available, which are reflected in Level 3 and can include fixed maturities across all asset classes. These models primarily use projected cash flows discounted using a rate derived from market interest rate curves and relevant risk spreads. As of March 31, 2011, less than 1% of our fixed maturities were valued using internal pricing models, which were classified as Level 3 assets accordingly.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

The primary inputs, by asset class, for valuations of the majority of our Level 2 investments from third party pricing vendors or our internal pricing valuation approach are described below.

***U.S. Government and Agencies/Non-U.S. Governments.*** Inputs include recently executed market transactions, interest rate yield curves, maturity dates, market price quotations and credit spreads relating to similar instruments.

***State and Political Subdivisions.*** Inputs include Municipal Securities Rulemaking Board reported trades, U.S. Treasury and other benchmark curves, material event notices, new issue data, and issuer financial statements.

***Corporate.*** Inputs include recently executed transactions, market price quotations, benchmark yields, issuer spreads and observations of equity and credit default swap curves related to the issuer. For private placement corporate securities valued through the matrix valuation approach inputs include the current U.S. Treasury curve and risk spreads based on sector, rating and average life of the issuance.

***RMBS, CMBS, CDOs and Other Debt Obligations.*** Inputs include cash flows, priority of the tranche in the capital structure, expected time to maturity for the specific tranche, reinvestment period remaining and performance of the underlying collateral including prepayments, defaults, deferrals, loss severity of defaulted collateral and, for RMBS, prepayment speed assumptions. Other inputs include market indices and recently executed market transactions.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

***Equity Securities***

Equity securities include mutual funds, common stock and nonredeemable preferred stock. Fair values of equity securities are determined using quoted prices in active markets for identical assets when available, which are reflected in Level 1. When quoted prices are not available, we may utilize internal valuation methodologies appropriate for the specific asset that use observable inputs such as underlying share prices, which are reflected in Level 2. Fair values might also be determined using broker quotes or through the use of internal models or analysis that incorporate significant assumptions deemed appropriate given the circumstances and consistent with what other market participants would use when pricing such securities, which are reflected in Level 3.

***Mortgage Loans***

Mortgage loans are not measured at fair value on a recurring basis. Fair values of commercial and residential mortgage loans are primarily determined by discounting the expected cash flows at current treasury rates plus an applicable risk spread, which reflects credit quality and maturity of the loans. The risk spread is based on market clearing levels for loans with comparable credit quality, maturities and risk. The fair value of mortgage loans may also be based on the fair value of the underlying real estate collateral less cost to sell, which is estimated using appraised values.

***Policy Loans***

Policy loans are not measured at fair value on a recurring basis. Fair values of policy loans are estimated by discounting expected cash flows using a risk-free rate based on the U.S. Treasury curve.

***Derivatives***

The fair values of exchange-traded derivatives are determined through quoted market prices, which are reflected in Level 1. Exchange-traded derivatives include interest rate and equity futures that are settled daily such that their fair value is not reflected in the consolidated statements of financial position. The fair values of over-the-counter derivative instruments are determined using either pricing valuation models that utilize

market observable inputs or broker quotes. The majority of our over-the-counter derivatives are valued with models that use market observable inputs, which are reflected in Level 2. Significant inputs include contractual terms, interest rates, currency exchange rates, credit spread curves, equity prices, and volatilities. These valuation models consider projected discounted cash flows, relevant swap curves, and appropriate implied volatilities. Certain over-the-counter derivatives utilize unobservable market data, primarily independent broker quotes that are nonbinding quotes based on models that do not reflect the result of market transactions, which are reflected in Level 3.

Our derivative contracts are generally documented under ISDA Master Agreements, which provide for legally enforceable set-off and close-out netting of exposures to specific counterparties. Collateral arrangements are bilateral and based on current ratings of each entity. We utilize the LIBOR interest rate curve to value our positions, which includes a credit spread. This credit spread incorporates an appropriate level of nonperformance risk into our valuations given the current ratings of our counterparties, as well as the collateral agreements in place. Counterparty credit risk is routinely monitored to ensure our adjustment for non-performance risk is appropriate.

**Interest Rate Contracts.** We use discounted cash flow valuation techniques to determine the fair value of interest rate swaps using observable swap curves as the inputs. These are reflected in Level 2. In addition, we have a limited number of complex inflation-linked interest rate swaps and interest rate collars that are valued using broker quotes. These are reflected in Level 3. We use option pricing models to determine the fair value of swaptions using observable swap interest rate curves and observable implied volatilities as inputs. These are reflected in Level 2.

**Foreign Exchange Contracts.** We use discounted cash flow valuation techniques that utilize observable swap curves and exchange rates as the inputs to determine the fair value of foreign currency swaps. These are reflected in Level 2. In addition, we have a limited number of non-standard currency swaps that are valued using broker quotes. These are reflected within Level 3. Currency forwards are valued using observable market inputs, including forward currency exchange rates. These are reflected in Level 2.

**Equity Contracts.** We use an option pricing model using observable implied volatilities, dividend yields, index prices and swap curves as the inputs to determine the fair value of equity options. These are reflected in Level 2.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

**Credit Contracts.** We use either the ISDA Credit Default Swap Standard discounted cash flow model that utilizes observable default probabilities and recovery rates as inputs or broker prices to determine the fair value of credit default swaps. These are reflected in Level 3.

**Other Investments**

Other investments reported at fair value primarily include seed money investments, for which the fair value is determined using the net asset value of the fund. The net asset value of the fund represents the price at which we feel we would be able to initiate a transaction. Seed money investments in mutual funds for which the net asset value is published are reflected in Level 1. Seed money investments in mutual funds or other investment funds in markets that do not have a published net asset value are reflected in Level 2.

Other investments reported at fair value also include commercial mortgage loans of consolidated VIEs for which the fair value option was elected, which are reflected in Level 3. Fair value of these commercial mortgage loans is computed utilizing a discount rate based on the current market. The market discount rate is then adjusted based on various factors that differentiate it from our pool of loans.

The carrying amounts of other assets classified as other investments in the accompanying consolidated statements of financial position, which are not measured at fair value on a recurring basis, approximate their fair values.

**Cash and Cash Equivalents**

Certain cash equivalents are reported at fair value on a recurring basis and include money market instruments and other short-term investments with maturities of less than three months. Fair values of these cash equivalents may be determined using public quotations, when available, which are reflected in Level 1. When public quotations are not available, because of the highly liquid nature of these assets, carrying amounts may be used to approximate fair values, which are reflected in Level 2.

The carrying amounts of cash and cash equivalents that are not reported at fair value on a recurring basis approximate their fair value.

***Separate Account Assets***

Separate account assets include equity securities, debt securities and derivative instruments, for which fair values are determined as previously described, and are reflected in Level 1, Level 2 and Level 3. Separate account assets also include commercial mortgage loans, for which the fair value is estimated by discounting the expected total cash flows using market rates that are applicable to the yield, credit quality and maturity of the loans. The market clearing spreads vary based on mortgage type, weighted average life, rating and liquidity. These are reflected in Level 3. Finally, separate account assets include real estate, for which the fair value is estimated using discounted cash flow valuation models that utilize public real estate market data inputs such as transaction prices, market rents, vacancy levels, leasing absorption, market cap rates and discount rates. In addition, each property is appraised annually by an independent appraiser. The real estate within the separate accounts is reflected in Level 3.

***Cash Collateral and Cash Collateral Payable***

Cash collateral is not measured at fair value on a recurring basis. The carrying amounts of cash collateral received and posted under derivative credit support annex (collateral) agreements and the carrying amount of the payable associated with our obligation to return the cash collateral received approximate their fair value.

***Investment-Type Insurance Contracts***

Investment-type insurance contracts are not measured at fair value on a recurring basis. The fair values of our reserves and liabilities for investment-type insurance contracts are estimated using discounted cash flow analyses based on current interest rates, including non-performance risk, being offered for similar contracts with maturities consistent with those remaining for the investment-type contracts being valued. Investment-type insurance contracts include insurance, annuity and other policy contracts that do not involve significant mortality or morbidity risk and are only a portion of the policyholder liabilities appearing in the consolidated statements of financial position. Insurance contracts include insurance, annuity and other policy contracts that do involve significant mortality or morbidity risk. The fair values for our insurance contracts, other than investment-type contracts, are not required to be disclosed.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

Certain annuity contracts and other investment-type insurance contracts include embedded derivatives that have been bifurcated from the host contract and that are measured at fair value on a recurring basis, which are reflected in Level 3. The key assumptions for calculating the fair value of the embedded derivative liabilities are market assumptions (such as equity market returns, interest rate levels, market volatility and correlations) and policyholder behavior assumptions (such as lapse, mortality, utilization and withdrawal patterns). They are valued using a combination of historical data and actuarial judgment. Stochastic models are used to value the embedded derivatives that incorporate a spread reflecting our own creditworthiness and risk margins.

The assumption for our own non-performance risk for investment-type insurance contracts and any embedded derivatives bifurcated from certain annuity and investment-type insurance contracts is based on the current market credit spreads for debt-like instruments that we have issued and are available in the market.

***Short-Term Debt***

Short-term debt is not measured at fair value on a recurring basis. The carrying amount of short-term debt approximates its fair value because of the relatively short time between origination of the debt instrument and its maturity.

***Long-Term Debt***

Long-term debt is not measured at fair value on a recurring basis. Fair values for debt issues are estimated using discounted cash flow analysis based on our incremental borrowing rate for similar borrowing arrangements.

***Separate Account Liabilities***

Separate account liabilities are not measured at fair value on a recurring basis. Fair values of separate account liabilities, excluding insurance-related elements, are estimated based on market assumptions around what a potential acquirer would pay for the associated block of business, including both the separate account assets and liabilities. As the applicable separate account assets are already reflected at fair value, any adjustment to the fair value of the block is an assumed adjustment to the separate account liabilities. To compute fair value, the separate

account liabilities are originally set to equal separate account assets because these are pass-through contracts. The separate account liabilities are reduced by the amount of future fees expected to be collected that are intended to offset upfront acquisition costs already incurred that a potential acquirer would not have to pay. The estimated future fees are adjusted by an adverse deviation discount and the amount is then discounted at a risk-free rate as measured by the yield on U.S. Treasury securities at maturities aligned with the estimated timing of fee collection.

### ***Bank Deposits***

Bank deposits are not measured at fair value on a recurring basis. The fair value of deposits of our Principal Bank subsidiary with no stated maturity, such as demand deposits, savings, and interest-bearing demand accounts, is equal to the amount payable on demand (i.e., their carrying amounts). The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount is estimated using the rates currently offered for deposits of similar remaining maturities.

### ***Other Liabilities***

Certain obligations reported in other liabilities include embedded derivatives to deliver underlying securities of structured investments to third parties. The fair value of the embedded derivatives is calculated based on the value of the underlying securities. We have an embedded derivative in which the fair value of the underlying securities is calculated utilizing the yield, credit quality and average maturity of each security, which is reflected in Level 3.

Additionally, obligations of consolidated VIEs for which the fair value option was elected are included in other liabilities. These obligations are valued either based on prices obtained from third party pricing vendors as utilized and described in our discussion of how fair value is determined for fixed maturities, which are reflected in Level 2, or broker quotes, which are reflected in Level 3.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)****Assets and liabilities measured at fair value on a recurring basis**

Assets and liabilities measured at fair value on a recurring basis are summarized below.

	Assets / (liabilities) measured at fair value	As of March 31, 2011		
		Fair value hierarchy level		
		Level 1	Level 2	Level 3
(in millions)				
<b>Assets</b>				
Fixed maturities, available-for-sale:				
U.S. government and agencies	\$ 551.0	\$ 29.5	\$ 521.5	\$
Non-U.S. governments	828.2		803.7	24.5
States and political subdivisions	2,665.1		2,665.1	
Corporate	33,654.6	96.8	33,012.6	545.2
Residential mortgage-backed pass-through securities	3,168.6		3,168.6	
Commercial mortgage-backed securities	3,940.2		3,921.2	19.0
Collateralized debt obligations	300.3		189.2	111.1
Other debt obligations	3,197.5		3,109.0	88.5
Total fixed maturities, available-for-sale	48,305.5	126.3	47,390.9	788.3
Fixed maturities, trading	1,006.3	77.8	658.9	269.6
Equity securities, available-for-sale	175.8	124.9	2.7	48.2
Equity securities, trading	389.7	276.4	113.3	
Derivative assets (1)	1,038.2		998.8	39.4
Other investments (2)	207.6	19.1	66.3	122.2
Cash equivalents (3)	1,234.7	72.3	1,162.4	
Sub-total excluding separate account assets	52,357.8	696.8	50,393.3	1,267.7
Separate account assets	71,724.5	53,381.9	14,543.1	3,799.5
<b>Total assets</b>	<b>\$ 124,082.3</b>	<b>\$ 54,078.7</b>	<b>\$ 64,936.4</b>	<b>\$ 5,067.2</b>
<b>Liabilities</b>				
Investment-type insurance contracts (4)	\$ (4.2)	\$	\$	\$ (4.2)
Derivative liabilities (1)	(1,208.6)		(1,023.6)	(185.0)
Other liabilities (4)	(246.6)		(87.7)	(158.9)
<b>Total liabilities</b>	<b>\$ (1,459.4)</b>	<b>\$</b>	<b>\$ (1,111.3)</b>	<b>\$ (348.1)</b>
<b>Net assets (liabilities)</b>	<b>\$ 122,622.9</b>	<b>\$ 54,078.7</b>	<b>\$ 63,825.1</b>	<b>\$ 4,719.1</b>



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

	Assets / (liabilities) measured at fair value	As of December 31, 2010			
		Fair value hierarchy level			
		Level 1	Level 2	Level 3	
(in millions)					
<b>Assets</b>					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 769.3	\$ 229.6	\$ 539.7	\$	
Non-U.S. governments	872.6		848.1		24.5
States and political subdivisions	2,656.4		2,656.4		
Corporate	33,892.5	95.4	33,245.0		552.1
Residential mortgage-backed pass-through securities	3,196.2		3,196.2		
Commercial mortgage-backed securities	3,842.2		3,826.0		16.2
Collateralized debt obligations	293.0		183.7		109.3
Other debt obligations	3,114.1		3,025.3		88.8
Total fixed maturities, available-for-sale	48,636.3	325.0	47,520.4		790.9
Fixed maturities, trading	1,120.3	159.8	691.4		269.1
Equity securities, available-for-sale	169.9	124.1	2.6		43.2
Equity securities, trading	316.9	212.9	104.0		
Derivative assets (1)	1,083.2		1,049.9		33.3
Other investments (2)	210.7	14.1	68.3		128.3
Cash equivalents (3)	1,247.2	217.3	1,029.9		
Sub-total excluding separate account assets	52,784.5	1,053.2	50,466.5		1,264.8
Separate account assets	69,555.3	51,012.9	14,770.9		3,771.5
<b>Total assets</b>	<b>\$ 122,339.8</b>	<b>\$ 52,066.1</b>	<b>\$ 65,237.4</b>	<b>\$</b>	<b>5,036.3</b>
<b>Liabilities</b>					
Investment-type insurance contracts (4)	\$ (6.6)	\$	\$	\$	(6.6)
Derivative liabilities (1)	(1,274.5)		(1,093.0)		(181.5)
Other liabilities (4)	(250.3)		(93.5)		(156.8)
<b>Total liabilities</b>	<b>\$ (1,531.4)</b>	<b>\$</b>	<b>\$ (1,186.5)</b>	<b>\$</b>	<b>(344.9)</b>
<b>Net assets (liabilities)</b>	<b>\$ 120,808.4</b>	<b>\$ 52,066.1</b>	<b>\$ 64,050.9</b>	<b>\$</b>	<b>4,691.4</b>

(1) Within the consolidated statements of financial position, derivative assets are reported with other investments and derivative liabilities are reported with other liabilities. Refer to Note 4, Derivative Financial Instruments, for further information on fair value by class of derivative instruments. Our derivatives are primarily Level 2, with the exception of some credit default swaps and other swaps that are Level 3.

(2) Primarily includes seed money investments and commercial mortgage loans of consolidated VIEs reported at fair value.

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

- (3) Includes money market instruments and short-term investments with a maturity date of three months or less when purchased.
- (4) Includes bifurcated embedded derivatives that are reported at fair value within the same line item in the consolidated statements of financial position in which the host contract is reported. Other liabilities also include obligations of consolidated VIEs reported at fair value.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)****Changes in Level 3 fair value measurements**

The reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) are summarized as follows:

	Beginning asset / (liability) balance as of December 31, 2010	For the three months ended March 31, 2011					Ending asset / (liability) balance as of March 31, 2011	Changes in unrealized gains (losses) included in net income relating to positions still held (1)
		Total realized/unrealized gains (losses) Included in net income (1)	Included in other comprehensive income	Purchases, sales, issuances and settlements (5) (in millions)	Transfers into Level 3	Transfers out of Level 3		
<b>Assets</b>								
Fixed maturities, available-for-sale:								
Non-U.S. governments	\$ 24.5	\$	\$	\$	\$	\$	\$ 24.5	\$
Corporate	552.1	(7.9)	4.7	(11.2)	27.5	(20.0)	545.2	(7.9)
Commercial mortgage-backed securities	16.2		2.6	0.2			19.0	
Collateralized debt obligations	109.3	(10.3)	14.7	(1.3)		(1.3)	111.1	(10.3)
Other debt obligations	88.8		0.5	(1.2)	0.4		88.5	
Total fixed maturities, available-for-sale	790.9	(18.2)	22.5	(13.5)	27.9	(21.3)	788.3	(18.2)
Fixed maturities, trading	269.1	(4.1)		4.6			269.6	(3.1)
Equity securities, available-for-sale	43.2		5.0				48.2	
Derivative assets	33.3	6.3	(0.1)	(0.1)			39.4	6.2
Other investments	128.3	(2.1)		(4.0)			122.2	(2.1)
Separate account assets (2)	3,771.5	73.7	(0.3)	(17.3)	3.1	(31.2)	3,799.5	71.8
<b>Liabilities</b>								
Investment-type insurance contracts	(6.6)	(4.5)		6.9			(4.2)	(4.3)
Derivative liabilities	(181.5)	1.4	2.0	(6.9)			(185.0)	2.5
Other liabilities (3)	(156.8)	4.4	0.2	(6.7)			(158.9)	4.4



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

	Beginning asset / (liability) balance as of December 31, 2009	For the three months ended March 31, 2010			Transfers in (out) of Level 3	Ending asset / (liability) balance as of March 31, 2010	Changes in unrealized gains (losses) included in net income relating to positions still held (1)
		Total realized/unrealized gains (losses) Included in net income (1)	Included in other comprehensive income	Purchases, sales, issuances and settlements (4)  (in millions)			
<b>Assets</b>							
Fixed maturities, available-for-sale:							
Non-U.S. governments	\$ 16.1	\$	\$ 0.1	\$ 8.3	\$	\$ 24.5	\$
State and political subdivisions	11.5				(11.5)		
Corporate	737.3	4.4	7.8	(70.2)	37.2	716.5	1.5
Commercial mortgage-backed securities	34.3		0.5	12.9		47.7	
Collateralized debt obligations	296.8	(11.6)	22.4	(11.6)	(22.1)	273.9	(6.4)
Other debt obligations	76.6		1.0	34.5		112.1	
Total fixed maturities, available-for-sale	1,172.6	(7.2)	31.8	(26.1)	3.6	1,174.7	(4.9)
Fixed maturities, trading	63.5	7.3		196.7		267.5	7.3
Equity securities, available-for-sale	71.7	2.8	(6.7)	(23.3)	(1.6)	42.9	2.8
Derivative assets	54.4	(9.0)		(2.6)		42.8	(7.9)
Other investments		3.7		113.6		117.3	3.7
Separate account assets (2)	4,120.7	(22.3)	(0.2)	(22.0)	(7.5)	4,068.7	(19.6)
<b>Liabilities</b>							
Investment-type insurance contracts	(23.6)	8.0		7.1		(8.5)	8.1
Derivative liabilities	(93.7)	4.5	(0.8)	(119.1)		(209.1)	2.7
Other liabilities (3)	(89.1)	0.4	(19.8)	(35.0)		(143.5)	0.4

(1) Both realized gains (losses) and mark-to-market unrealized gains (losses) are generally reported in net realized capital gains (losses) within the consolidated statements of operations. Realized and unrealized gains (losses) on certain fixed maturities, trading and certain derivatives used in relation to certain trading portfolios are reported in net investment income within the consolidated statements of operations.

(2) Gains and losses for separate account assets do not impact net income as the change in value of separate account assets is offset by a change in value of separate account liabilities. Foreign currency translation adjustments related to the Principal International segment separate account assets are recorded in AOCI and are offset by foreign currency translation adjustments of the corresponding separate account liabilities.

(3) Certain embedded derivatives reported in other liabilities are part of a cash flow hedge, with the effective portion of the unrealized gains (losses) recorded in AOCI.

(4) As a result of our implementation of new authoritative guidance related to the accounting for VIEs effective January 1, 2010, certain previously unconsolidated VIEs were consolidated and certain previously consolidated VIEs were deconsolidated. The fair value of the Level 3 assets and liabilities of the newly consolidated and deconsolidated VIEs is primarily included in fixed maturities, trading; other investments; derivative liabilities and other liabilities.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

(5) Gross purchases, sales, issuances and settlements were:

	For the three months ended March 31, 2011				Net purchases, sales, issuances and settlements
	Purchases	Sales	Issuances (in millions)	Settlements	
<b>Assets</b>					
Fixed maturities, available-for-sale:					
Corporate	\$ 7.6	\$ (16.5)	\$	\$ (2.3)	\$ (11.2)
Commercial mortgage-backed securities				0.2	0.2
Collateralized debt obligations	0.3	(0.4)		(1.2)	(1.3)
Other debt obligations				(1.2)	(1.2)
Total fixed maturities, available-for-sale	7.9	(16.9)		(4.5)	(13.5)
Fixed maturities, trading	10.0	(5.3)		(0.1)	4.6
Derivative assets		(0.1)			(0.1)
Other investments				(4.0)	(4.0)
Separate account assets	35.2	(44.7)		(7.8)	(17.3)
<b>Liabilities</b>					
Investment-type insurance contracts			6.3	0.6	6.9
Derivative liabilities	(9.4)	2.5			(6.9)
Other liabilities	(2.1)			(4.6)	(6.7)

**Transfers**

Transfers between fair value hierarchy levels are recognized at the beginning of the reporting period.

Assets transferred into Level 3 during the three months ended March 31, 2011 and 2010, were \$31.0 million and \$90.0 million, respectively. The majority of assets transferred into Level 3 primarily include assets added to our watch list that were previously priced using a matrix pricing valuation approach that may no longer be relevant when applied to asset-specific situations.

Assets transferred out of Level 3 during the three months ended March 31, 2011 and 2010 were \$52.5 million and \$95.5 million, respectively. The majority of assets that transferred out of Level 3 include those for which we are now able to obtain pricing from a recognized third party

pricing vendor.

We did not have significant transfers between Level 1 and Level 2 during the three months ended March 31, 2011. During the three months ended March 31, 2010, we had significant transfers of separate account assets between Level 1 and Level 2, primarily related to foreign equity securities. When these securities are valued at the local close price of the exchange where the assets traded, they are reflected in Level 1. When events materially affecting the value occur between the close of the local exchange and the New York Stock Exchange, we use adjusted prices determined by a third party pricing vendor to update the foreign market closing prices and the fair value is reflected in Level 2. During the three months ended March 31, 2010, \$3,300.4 million of separate account assets transferred out of Level 2 into Level 1.

Other transfers into and out of Level 2 during the three months ended March 31, 2011 and 2010, primarily included those that transferred out of and into Level 3, respectively.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

**Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis**

Certain assets are measured at fair value on a nonrecurring basis. During the three months ended March 31, 2011, mortgage loans had been marked to fair value of \$49.7 million. The net impact of impairments and improvements in estimated fair value of previously impaired loans resulted in a net gain of \$0.8 million that was recorded in net realized capital gains (losses) as part of the mortgage loan valuation allowance. These collateral-dependent mortgage loans are a Level 3 fair value measurement, as fair value is based on the fair value of the underlying real estate collateral, which is estimated using appraised values that involve at least one significant unobservable input.

During the three months ended March 31, 2011, certain mortgage servicing rights had been marked to fair value of \$1.1 million. The net impact of impairments and subsequent improvements in estimated fair value of previously impaired mortgage servicing rights resulted in a net gain of \$0.1 million that was recorded in operating expenses. These mortgage servicing rights are a Level 3 fair value measurement, as fair value is determined by calculating the present value of the future servicing cash flows from the underlying mortgage loans.

During the three months ended March 31, 2010, certain mortgage loans had been marked to fair value of \$77.4 million. The net impact of impairments and improvements in estimated fair value of previously impaired loans resulted in a net loss of \$8.5 million for the three months ended March 31, 2010, that was recorded in net realized capital gains (losses) as part of the mortgage loan valuation allowance. These collateral-dependent mortgage loans are a Level 3 fair value measurement, as fair value is based on the fair value of the underlying real estate collateral, which is estimated using appraised values that involve at least one significant unobservable input.

During the three months ended March 31, 2010, certain real estate had been written down to fair value of \$0.8 million. This write down resulted in a loss of \$0.2 million for the three months ended March 31, 2010, that was recorded in net realized capital gains (losses). This is a Level 3 fair value measurement, as the fair value of real estate is estimated using appraised values that involve significant unobservable inputs.

**Fair Value Option**

As a result of our implementation of new authoritative guidance related to the accounting for VIEs effective January 1, 2010, we elected fair value accounting for certain assets and liabilities of newly consolidated VIEs for which it was not practicable for us to determine the carrying value. The fair value option was elected for commercial mortgage loans reported with other investments and obligations reported with other liabilities in the consolidated statements of financial position. The changes in fair value of these items are reported in net realized capital gains (losses) on the consolidated statements of operations.

The fair value and aggregate contractual principal amounts of commercial mortgage loans for which the fair value option has been elected were \$122.2 million and \$120.4 million as of March 31, 2011, and \$128.3 million and \$124.4 million as of December 31, 2010, respectively. The change in fair value of the loans resulted in a \$(2.1) million and \$3.7 million pre-tax gain (loss) for the three months ended March 31, 2011 and 2010, respectively, none of which related to instrument-specific credit risk. None of these loans were more than 90 days past due or in nonaccrual status. Interest income on these commercial mortgage loans is included in net investment income on the consolidated statements of operations and is recorded based on the effective interest rates as determined at the closing of the loan. For the three months ended March 31, 2011 and 2010, we recorded \$2.5 million and \$2.8 million, respectively, of interest income on these commercial mortgage loans.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**9. Fair Value Measurements (continued)**

The fair value and aggregate unpaid principal amounts of obligations for which the fair value option has been elected were \$106.4 million and \$192.9 million as of March 31, 2011, and \$114.5 million and \$186.5 million as of December 31, 2010, respectively. For the three months ended March 31, 2011 and 2010, the change in fair value of the obligations resulted in a pre-tax gain (loss) of \$6.3 million and \$(3.0) million, which includes a pre-tax gain of \$4.4 million and \$0.4 million related to instrument-specific credit risk that is estimated based on credit spreads and quality ratings, respectively. Interest expense recorded on these obligations is included in operating expenses on the consolidated statements of operations and was \$1.9 million and \$2.3 million for the three months ended March 31, 2011 and 2010, respectively.

**10. Segment Information**

We provide financial products and services through the following segments: Retirement and Investor Services, Principal Global Investors, Principal International and U.S. Insurance Solutions. In addition, there is a Corporate segment. The segments are managed and reported separately because they provide different products and services, have different strategies or have different markets and distribution channels.

The Retirement and Investor Services segment provides retirement and related financial products and services primarily to businesses, their employees and other individuals.

The Principal Global Investors segment provides asset management services to our asset accumulation business, our insurance operations, the Corporate segment and third-party clients.

The Principal International segment has operations in Brazil, Chile, China, Hong Kong Special Administrative Region, India, Indonesia, Malaysia, Mexico, Singapore and Thailand. We focus on countries with large middle classes, favorable demographics and growing long-term savings, ideally with defined contribution markets. We entered these countries through acquisitions, start-up operations and joint ventures.

The U.S. Insurance Solutions segment provides individual life insurance and specialty benefits, which consists of group dental and vision insurance, individual and group disability insurance, group life insurance, wellness services and fee-for-service claims administration, throughout the United States.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

The Corporate segment manages the assets representing capital that has not been allocated to any other segment. Financial results of the Corporate segment primarily reflect our financing activities (including interest expense and preferred stock dividends), income on capital not allocated to other segments, inter-segment eliminations, income tax risks and certain income, expenses and other after-tax adjustments not allocated to the segments based on the nature of such items.

Management uses segment operating earnings in goal setting, as a basis for determining employee compensation and in evaluating performance on a basis comparable to that used by securities analysts. We determine segment operating earnings by adjusting U.S. GAAP net income for net realized capital gains (losses), as adjusted, and other after-tax adjustments which management believes are not indicative of overall operating trends. Net realized capital gains (losses), as adjusted, are net of income taxes, related changes in the amortization pattern of DPAC and sales inducements, recognition of deferred front-end fee revenues for sales charges on retirement products and services, net realized capital gains and losses distributed, noncontrolling interest capital gains and losses and certain market value adjustments to fee revenues. Net realized capital gains (losses), as adjusted, exclude periodic settlements and accruals on derivative instruments not designated as hedging instruments and exclude certain market value adjustments of embedded derivatives and realized capital gains (losses) associated with our exited group medical insurance business. Segment operating revenues exclude net realized capital gains (losses) (except periodic settlements and accruals on derivatives not designated as hedging instruments), including their impact on recognition of front-end fee revenues and certain market value adjustments to fee revenues, revenue from our exited group medical insurance business and revenue from our terminated commercial mortgage securities issuance operation. Segment operating revenues include operating revenues from real estate properties that qualify for discontinued operations. While these items may be significant components in understanding and assessing the consolidated financial performance, management believes the presentation of segment operating earnings enhances the understanding of our results of operations by highlighting earnings attributable to the normal, ongoing operations of the business.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**10. Segment Information (continued)**

The accounting policies of the segments are consistent with the accounting policies for the consolidated financial statements, with the exception of income tax allocation. The Corporate segment functions to absorb the risk inherent in interpreting and applying tax law. The segments are allocated tax adjustments consistent with the positions we took on tax returns. The Corporate segment results reflect any differences between the tax returns and the estimated resolution of any disputes.

The following tables summarize selected financial information by segment and reconcile segment totals to those reported in the consolidated financial statements:

	March 31, 2011	December 31, 2010
	(in millions)	
<b>Assets:</b>		
Retirement and Investor Services	\$ 111,593.9	\$ 110,043.0
Principal Global Investors	1,345.3	1,308.1
Principal International	13,054.3	12,774.5
U.S. Insurance Solutions	16,920.8	16,558.2
Corporate	4,635.4	4,947.3
Total consolidated assets	\$ 147,549.7	\$ 145,631.1

	For the three months ended March 31, 2011	2010
	(in millions)	
<b>Operating revenues by segment:</b>		
Retirement and Investor Services	\$ 1,017.8	\$ 1,012.7
Principal Global Investors	125.3	113.8
Principal International	206.2	181.1
U.S. Insurance Solutions	731.2	692.1
Corporate	(33.8)	(27.2)
Total segment operating revenues	2,046.7	1,972.5
Net realized capital losses (except periodic settlements and accruals on non-hedge derivatives), including recognition of front-end fee revenues and certain market value adjustments to fee revenues	(81.8)	(69.8)
Exited group medical insurance business	254.9	361.3
Total revenues per consolidated statements of operations	\$ 2,219.8	\$ 2,264.0
<b>Operating earnings (loss) by segment, net of related income taxes:</b>		
Retirement and Investor Services	\$ 159.3	\$ 157.0
Principal Global Investors	16.6	12.0
Principal International	28.5	37.9
U.S. Insurance Solutions	59.5	44.1

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Corporate		<b>(32.1)</b>		(29.6)
Total segment operating earnings, net of related income taxes		<b>231.8</b>		221.4
Net realized capital losses, as adjusted (1)		<b>(52.6)</b>		(56.7)
Other after-tax adjustments (2)		<b>17.1</b>		26.1
Net income available to common stockholders per consolidated statements of operations	\$	<b>196.3</b>	\$	190.8

---

(1) Net realized capital losses, as adjusted, is derived as follows:

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**10. Segment Information (continued)**

	For the three months ended March 31,	
	2011	2010
	(in millions)	
<b>Net realized capital losses:</b>		
Net realized capital losses	\$ (58.0)	\$ (45.5)
Periodic settlements and accruals on non-hedge derivatives	(22.3)	(24.7)
Recognition of front-end fee revenues	(1.5)	0.4
Net realized capital losses, net of related revenue adjustments	(81.8)	(69.8)
Amortization of deferred policy acquisition and sales inducement costs	25.6	(14.8)
Capital gains distributed	(8.7)	(2.0)
Certain market value adjustments of embedded derivatives	3.8	2.2
Net realized capital (gains) losses associated with exited group medical insurance business	(0.1)	0.5
Noncontrolling interest capital gains	(17.5)	(4.0)
Income tax effect	26.1	31.2
Net realized capital losses, as adjusted	\$ (52.6)	\$ (56.7)

(2) For the three months ended March 31, 2011, other after-tax adjustments included the positive effect of gains associated with our exited group medical insurance business that does not yet qualify for discontinued operations accounting treatment under U.S. GAAP.

For the three months ended March 31, 2010, other after-tax adjustments included the positive effect of gains associated with our exited group medical insurance business that does not yet qualify for discontinued operations accounting treatment under U.S. GAAP (\$33.9 million) and the negative effect resulting from the tax impact of healthcare reform, which eliminates the tax deductibility of retiree prescription drug expenses related to our employees incurred after 2012 (\$7.8 million).

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**10. Segment Information (continued)**

The following table summarizes operating revenues for our products and services:

	For the three months ended March 31,	
	2011	2010
	(in millions)	
Retirement and Investor Services:		
Full-service accumulation	\$ 343.3	\$ 330.3
Principal Funds	141.6	123.4
Individual annuities	274.2	251.1
Bank and trust services	23.8	23.1
Eliminations	(28.9)	(25.6)
Total Accumulation	754.0	702.3
Investment only	135.6	175.5
Full-service payout	128.2	134.9
Total Guaranteed	263.8	310.4
Total Retirement and Investor Services	1,017.8	1,012.7
Principal Global Investors (1)	125.3	113.8
Principal International	206.2	181.1
U.S. Insurance Solutions:		
Individual life insurance	357.5	345.0
Specialty benefits insurance	373.7	347.1
Total U.S. Insurance Solutions	731.2	692.1
Corporate	(33.8)	(27.2)
Total operating revenues	\$ 2,046.7	\$ 1,972.5
Total operating revenues	\$ 2,046.7	\$ 1,972.5
Net realized capital losses (except periodic settlements and accruals on non-hedge derivatives), including recognition of front-end fee revenues and certain market value adjustments to fee revenues	(81.8)	(69.8)
Exited group medical insurance business	254.9	361.3
Total revenues per consolidated statements of operations	\$ 2,219.8	\$ 2,264.0

(1) Reflects inter-segment revenues of \$51.7 million and \$49.8 million for the three months ended March 31, 2011 and 2010, respectively. These revenues are eliminated within the Corporate segment.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**11. Stock-Based Compensation Plans**

As of March 31, 2011, we have the 2010 Stock Incentive Plan, the Employee Stock Purchase Plan, the 2005 Directors Stock Plan, the Stock Incentive Plan, the Directors Stock Plan and the Long-Term Performance Plan ( Stock-Based Compensation Plans ). As of May 17, 2005, no new grants will be made under the Stock Incentive Plan, the Directors Stock Plan or the Long-Term Performance Plan.

As of March 31, 2011, the maximum number of new shares of common stock that were available for grant under the 2010 Stock Incentive Plan and the 2005 Directors Stock Plan was 10.6 million.

The compensation cost that was charged against income for stock-based awards granted under the Stock-Based Compensation Plans was as follows:

	For the three months ended March 31,	
	2011	2010
	(in millions)	
Compensation cost	\$ 11.8	\$ 12.9
Related income tax benefit	4.0	4.0
Capitalized as part of an asset	0.8	0.5

**Nonqualified Stock Options**

Nonqualified stock options were granted to certain employees under the 2010 Stock Incentive Plan. Total options granted were 0.5 million for the three months ended March 31, 2011. The fair value of these options was determined using the Black-Scholes option valuation model assuming a weighted-average dividend yield of 1.6 percent, a weighted-average expected volatility of 67.9 percent, a weighted-average risk-free interest rate of 2.5 percent and a weighted-average expected term of 6 years. The weighted-average estimated fair value of stock options granted during the three months ended March 31, 2011, was \$18.82 per share.

As of March 31, 2011, there were \$11.1 million of total unrecognized compensation costs related to nonvested stock options. The costs are expected to be recognized over a weighted-average service period of approximately 1.8 years.

**Performance Share Awards**

Performance share awards were granted to certain employees under the 2010 Stock Incentive Plan. Total performance share awards granted were 0.3 million for the three months ended March 31, 2011. The performance share awards granted represent initial target awards and do not reflect potential increases or decreases resulting from the final performance objective to be determined at the end of the performance period. The actual number of shares to be awarded at the end of each performance period will range between 0% and 150% of the initial target awards. The fair value of performance share awards is determined based on the closing stock price of our common shares on the grant date. The weighted-average grant date fair value of these performance share awards granted was \$34.26 per common share.

As of March 31, 2011, there were \$11.7 million of total unrecognized compensation costs related to nonvested performance share awards granted. The costs are expected to be recognized over a weighted-average service period of approximately 1.6 years.

### **Restricted Stock Units**

Restricted stock units were issued to certain employees and agents pursuant to the 2010 Stock Incentive Plan. Total restricted stock units granted were 0.8 million for the three months ended March 31, 2011. The fair value of restricted stock units is determined based on the closing stock price of our common shares on the grant date. The weighted-average grant date fair value of these restricted stock units granted was \$34.26 per common share.

As of March 31, 2011, there were \$46.0 million of total unrecognized compensation costs related to nonvested restricted stock unit awards granted. The costs are expected to be recognized over a weighted-average period of approximately 2.3 years.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**12. Earnings Per Common Share**

The computations of the basic and diluted per share amounts were as follows:

	For the three months ended March 31,	
	2011	2010
	(in millions, except per share data)	
Net income	\$ 223.1	\$ 203.6
Subtract:		
Net income attributable to noncontrolling interest	18.6	4.6
Preferred stock dividends	8.2	8.2
Net income available to common stockholders	\$ 196.3	\$ 190.8
Weighted-average shares outstanding		
Basic	321.3	319.8
Dilutive effects:		
Stock options	1.4	0.9
Restricted stock units	1.7	1.4
Performance share awards	0.3	
Diluted	324.7	322.1
Net income per common share:		
Basic	\$ 0.61	\$ 0.60
Diluted	\$ 0.60	\$ 0.59

The calculation of diluted earnings per share for the three months ended March 31, 2011 and 2010, excludes the incremental effect related to certain outstanding stock-based compensation grants due to their anti-dilutive effect.

**13. Condensed Consolidating Financial Information**

Principal Life has established special purpose entities to issue secured medium-term notes. Under the program, the payment obligations of principal and interest on the notes are secured by funding agreements issued by Principal Life. Principal Life's payment obligations on the funding agreements are fully and unconditionally guaranteed by PFG. All of the outstanding stock of Principal Life is indirectly owned by PFG and PFG is the only guarantor of the payment obligations of the funding agreements.

The following tables set forth condensed consolidating financial information of (i) PFG, (ii) Principal Life, (iii) Principal Financial Services, Inc. ( PFS ) and all other direct and indirect subsidiaries of PFG on a combined basis and (iv) the eliminations necessary to arrive at the information for PFG on a consolidated basis as of March 31, 2011 and December 31, 2010, and for the three months ended March 31, 2011 and 2010.

In presenting the condensed consolidating financial statements, the equity method of accounting has been applied to (i) PFG's interest in PFS, (ii) Principal Life's interest in all direct subsidiaries of Principal Life and (iii) PFS's interest in Principal Life even though all such subsidiaries meet the requirements to be consolidated under U.S. GAAP. Earnings of subsidiaries are, therefore, reflected in the parent's investment and earnings. All intercompany balances and transactions, including elimination of the parent's investment in subsidiaries, between PFG, Principal Life and PFS and all other subsidiaries have been eliminated, as shown in the column Eliminations. These condensed consolidating financial statements should be read in conjunction with the consolidated financial statements. The financial information may not necessarily be indicative of results of operations, cash flows or financial position had the subsidiaries operated as independent entities.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)****Condensed Consolidating Statements of Financial Position****March 31, 2011**

	Principal Financial Group, Inc. Parent Only	Principal Life Insurance Company Only	Principal Financial Services, Inc. and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Assets</b>					
Fixed maturities, available-for-sale	\$	\$ 42,354.3	\$ 6,375.1	\$ (423.9)	\$ 48,305.5
Fixed maturities, trading	190.1	456.4	359.8		1,006.3
Equity securities, available-for-sale		171.2	4.6		175.8
Equity securities, trading		0.3	389.4		389.7
Mortgage loans		9,257.9	2,028.7	(386.6)	10,900.0
Real estate		9.4	1,002.2	(1.6)	1,010.0
Policy loans		867.3	25.7		893.0
Investment in unconsolidated entities	10,464.2	3,190.1	5,123.8	(18,013.0)	765.1
Other investments	6.1	1,772.0	803.5	(670.3)	1,911.3
Cash and cash equivalents	871.8	354.6	819.6	(61.8)	1,984.2
Accrued investment income	0.4	615.3	63.8	(3.9)	675.6
Premiums due and other receivables	187.4	907.1	519.2	(303.8)	1,309.9
Deferred policy acquisition costs		3,266.4	283.5		3,549.9
Property and equipment		383.7	65.0		448.7
Goodwill		54.3	290.2		344.5
Other intangibles		30.2	799.1		829.3
Separate account assets		64,645.2	7,079.3		71,724.5
Other assets	14.7	733.7	1,159.6	(581.6)	1,326.4
<b>Total assets</b>	<b>\$ 11,734.7</b>	<b>\$ 129,069.4</b>	<b>\$ 27,192.1</b>	<b>\$ (20,446.5)</b>	<b>\$ 147,549.7</b>
<b>Liabilities</b>					
Contractholder funds	\$	\$ 36,582.4	\$ 287.8	\$ (260.9)	\$ 36,609.3
Future policy benefits and claims		16,041.1	3,996.9	(62.7)	19,975.3
Other policyholder funds		584.1	23.5	(0.1)	607.5
Short-term debt			106.8		106.8
Long-term debt	1,351.7	99.5	547.7	(419.1)	1,579.8
Income taxes currently payable	(13.0)	(187.0)	26.3	177.3	3.6
Deferred income taxes	(19.6)	246.4	330.4	(14.5)	542.7
Separate account liabilities		64,645.2	7,079.3		71,724.5
Other liabilities	228.0	3,041.9	4,139.7	(1,382.2)	6,027.4
<b>Total liabilities</b>	<b>1,547.1</b>	<b>121,053.6</b>	<b>16,538.4</b>	<b>(1,962.2)</b>	<b>137,176.9</b>
<b>Stockholders equity</b>					

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Series A preferred stock					
Series B preferred stock	<b>0.1</b>				<b>0.1</b>
Common stock	<b>4.5</b>	<b>2.5</b>		<b>(2.5)</b>	<b>4.5</b>
Additional paid-in capital	<b>9,580.1</b>	<b>5,945.1</b>	<b>8,135.1</b>	<b>(14,080.2)</b>	<b>9,580.1</b>
Retained earnings	<b>4,808.6</b>	<b>1,650.0</b>	<b>1,762.1</b>	<b>(3,412.1)</b>	<b>4,808.6</b>
Accumulated other comprehensive income	<b>525.5</b>	<b>418.2</b>	<b>567.0</b>	<b>(985.2)</b>	<b>525.5</b>
Treasury stock, at cost	<b>(4,731.2)</b>				<b>(4,731.2)</b>
Total stockholders' equity attributable to PFG	<b>10,187.6</b>	<b>8,015.8</b>	<b>10,464.2</b>	<b>(18,480.0)</b>	<b>10,187.6</b>
Noncontrolling interest			<b>189.5</b>	<b>(4.3)</b>	<b>185.2</b>
Total stockholders' equity	<b>10,187.6</b>	<b>8,015.8</b>	<b>10,653.7</b>	<b>(18,484.3)</b>	<b>10,372.8</b>
Total liabilities and stockholders' equity	<b>\$ 11,734.7</b>	<b>\$ 129,069.4</b>	<b>\$ 27,192.1</b>	<b>\$ (20,446.5)</b>	<b>\$ 147,549.7</b>

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)****Condensed Consolidating Statements of Financial Position****December 31, 2010**

	Principal Financial Group, Inc. Parent Only	Principal Life Insurance Company Only	Principal Financial Services, Inc. and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Assets</b>					
Fixed maturities, available-for-sale	\$ 199.9	\$ 42,478.2	\$ 6,381.9	\$ (423.7)	\$ 48,636.3
Fixed maturities, trading	274.9	475.8	369.6		1,120.3
Equity securities, available-for-sale		165.8	4.1		169.9
Equity securities, trading		0.3	316.6		316.9
Mortgage loans		9,466.9	2,072.3	(414.1)	11,125.1
Real estate		9.6	1,055.6	(1.7)	1,063.5
Policy loans		878.3	25.6		903.9
Investment in unconsolidated entities	10,195.1	3,433.6	4,841.9	(17,734.6)	736.0
Other investments	5.6	1,603.8	769.0	(472.8)	1,905.6
Cash and cash equivalents	370.9	699.8	719.9	86.8	1,877.4
Accrued investment income	0.8	607.4	62.5	(4.6)	666.1
Premiums due and other receivables		862.6	405.4	(205.0)	1,063.0
Deferred policy acquisition costs		3,258.7	271.1		3,529.8
Property and equipment		389.6	69.1		458.7
Goodwill		54.3	291.1		345.4
Other intangibles		30.5	804.1		834.6
Separate account assets		62,738.4	6,816.9		69,555.3
Other assets	13.6	716.0	1,146.3	(552.6)	1,323.3
<b>Total assets</b>	<b>\$ 11,060.8</b>	<b>\$ 127,869.6</b>	<b>\$ 26,423.0</b>	<b>\$ (19,722.3)</b>	<b>\$ 145,631.1</b>
<b>Liabilities</b>					
Contractholder funds	\$	\$ 37,353.3	\$ 208.9	\$ (261.1)	\$ 37,301.1
Future policy benefits and claims		16,082.5	4,013.3	(49.5)	20,046.3
Other policyholder funds		569.2	23.0		592.2
Short-term debt			107.9		107.9
Long-term debt	1,351.7	99.5	581.0	(448.5)	1,583.7
Income taxes currently payable	(18.8)	(188.0)	28.5	184.5	6.2
Deferred income taxes	(21.6)	134.8	309.8	(13.1)	409.9
Separate account liabilities		62,738.4	6,816.9		69,555.3
Other liabilities	21.7	3,264.6	3,977.1	(1,119.9)	6,143.5
<b>Total liabilities</b>	<b>1,333.0</b>	<b>120,054.3</b>	<b>16,066.4</b>	<b>(1,707.6)</b>	<b>135,746.1</b>
<b>Stockholders equity</b>					

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Series A preferred stock					
Series B preferred stock	0.1				0.1
Common stock	4.5	2.5		(2.5)	4.5
Additional paid-in capital	9,563.8	6,145.0	8,334.0	(14,479.0)	9,563.8
Retained earnings	4,612.3	1,472.4	1,546.3	(3,018.7)	4,612.3
Accumulated other comprehensive income	272.4	195.4	314.8	(510.2)	272.4
Treasury stock, at cost	(4,725.3)				(4,725.3)
Total stockholders' equity attributable to PFG	9,727.8	7,815.3	10,195.1	(18,010.4)	9,727.8
Noncontrolling interest			161.5	(4.3)	157.2
Total stockholders' equity	9,727.8	7,815.3	10,356.6	(18,014.7)	9,885.0
Total liabilities and stockholders' equity	\$ 11,060.8	\$ 127,869.6	\$ 26,423.0	\$ (19,722.3)	\$ 145,631.1

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)****Condensed Consolidating Statements of Operations****For the three months ended March 31, 2011**

	Principal Financial Group, Inc. Parent Only	Principal Life Insurance Company Only	Principal Financial Services, Inc. and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Revenues</b>					
Premiums and other considerations	\$	\$ 719.0	\$ 78.1	\$	\$ 797.1
Fees and other revenues		395.6	300.1	(74.9)	620.8
Net investment income	10.8	643.8	183.6	21.7	859.9
Net realized capital gains (losses), excluding impairment losses on available-for-sale securities		(25.9)	21.9	(1.6)	(5.6)
Total other-than-temporary impairment losses on available-for-sale securities		(11.8)	(2.2)		(14.0)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income		(39.2)	0.8		(38.4)
Net impairment losses on available-for-sale securities		(51.0)	(1.4)		(52.4)
Net realized capital gains (losses)		(76.9)	20.5	(1.6)	(58.0)
Total revenues	10.8	1,681.5	582.3	(54.8)	2,219.8
<b>Expenses</b>					
Benefits, claims and settlement expenses		1,055.2	139.7	(3.4)	1,191.5
Dividends to policyholders		53.6			53.6
Operating expenses	29.2	441.0	286.1	(65.1)	691.2
Total expenses	29.2	1,549.8	425.8	(68.5)	1,936.3
Income (loss) before income taxes	(18.4)	131.7	156.5	13.7	283.5
Income taxes (benefits)	(7.0)	32.2	35.2		60.4
Equity in the net income of subsidiaries	215.9	78.1	113.2	(407.2)	
Net income	204.5	177.6	234.5	(393.5)	223.1





Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Operations**  
**For the three months ended March 31, 2010**

	Principal Financial Group, Inc. Parent Only	Principal Life Insurance Company Only	Principal Financial Services, Inc. and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Revenues</b>					
Premiums and other considerations	\$	\$ 810.4	\$ 68.5	\$	\$ 878.9
Fees and other revenues		366.0	280.2	(78.6)	567.6
Net investment income	8.9	691.5	146.4	16.2	863.0
Net realized capital gains (losses), excluding impairment losses on available-for-sale securities	0.7	(15.6)	52.2	(3.6)	33.7
Total other-than-temporary impairment losses on available-for-sale securities		(82.3)	(2.3)		(84.6)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to other comprehensive income		4.4	1.0		5.4
Net impairment losses on available-for-sale securities		(77.9)	(1.3)		(79.2)
Net realized capital gains (losses)	0.7	(93.5)	50.9	(3.6)	(45.5)
Total revenues	9.6	1,774.4	546.0	(66.0)	2,264.0
<b>Expenses</b>					
Benefits, claims and settlement expenses		1,165.1	115.5	(5.3)	1,275.3
Dividends to policyholders		56.5			56.5
Operating expenses	29.1	459.6	252.5	(65.3)	675.9
Total expenses	29.1	1,681.2	368.0	(70.6)	2,007.7
Income (loss) before income taxes	(19.5)	93.2	178.0	4.6	256.3
Income taxes (benefits)	(7.6)	13.3	47.0		52.7
Equity in the net income of subsidiaries	210.9	82.6	85.7	(379.2)	
Net income	199.0	162.5	216.7	(374.6)	203.6
Net income attributable to noncontrolling interest			5.8	(1.2)	4.6

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Net income attributable to PFG	199.0	162.5	210.9	(373.4)	199.0
Preferred stock dividends	8.2				8.2
Net income available to common stockholders	\$ 190.8	\$ 162.5	\$ 210.9	\$ (373.4)	\$ 190.8

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)****Condensed Consolidating Statements of Cash Flows****For the three months ended March 31, 2011**

	Principal Financial Group, Inc. Parent Only	Principal Life Insurance Company Only	Principal Financial Services, Inc. and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Operating activities</b>					
Net cash provided by operating activities	\$ 99.9	\$ 1,034.6	\$ 206.0	\$ (145.0)	\$ 1,195.5
<b>Investing activities</b>					
Available-for-sale securities:					
Purchases	(4.4)	(1,426.9)	(230.3)	(4.8)	(1,666.4)
Sales	200.0	278.3	58.1		536.4
Maturities	4.4	1,510.9	210.3		1,725.6
Mortgage loans acquired or originated		(100.5)	(41.2)	17.8	(123.9)
Mortgage loans sold or repaid		301.4	67.5	(45.2)	323.7
Real estate acquired			(7.0)		(7.0)
Net purchases of property and equipment		(3.7)	(0.4)		(4.1)
Dividends and returns of capital received from unconsolidated entities	206.0	138.9	206.0	(550.9)	
Net change in other investments		(3.6)	(64.2)	(0.6)	(68.4)
Net cash provided by investing activities	406.0	694.8	198.8	(583.7)	715.9
<b>Financing activities</b>					
Issuance of common stock	9.1				9.1
Acquisition of treasury stock	(5.9)				(5.9)
Proceeds from financing element derivatives		19.4			19.4
Payments for financing element derivatives		(12.1)			(12.1)
Excess tax benefits from share-based payment arrangements		0.6	1.0		1.6
Dividends to preferred stockholders	(8.2)				(8.2)
Dividends and capital paid to parent		(206.0)	(344.9)	550.9	
Issuance of long-term debt			0.6		0.6
Principal repayments of long-term debt			(30.9)	29.2	(1.7)

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Net proceeds from short-term borrowings			<b>0.2</b>		<b>0.2</b>
Investment contract deposits	<b>798.6</b>		<b>94.7</b>		<b>893.3</b>
Investment contract withdrawals	<b>(2,674.2)</b>				<b>(2,674.2)</b>
Net decrease in banking operation deposits			<b>(25.8)</b>		<b>(25.8)</b>
Other	<b>(0.9)</b>				<b>(0.9)</b>
Net cash used in financing activities	<b>(5.0)</b>	<b>(2,074.6)</b>	<b>(305.1)</b>	<b>580.1</b>	<b>(1,804.6)</b>
Net increase (decrease) in cash and cash equivalents	<b>500.9</b>	<b>(345.2)</b>	<b>99.7</b>	<b>(148.6)</b>	<b>106.8</b>
Cash and cash equivalents at beginning of year	<b>370.9</b>	<b>699.8</b>	<b>719.9</b>	<b>86.8</b>	<b>1,877.4</b>
Cash and cash equivalents at end of year	<b>\$ 871.8</b>	<b>\$ 354.6</b>	<b>\$ 819.6</b>	<b>\$ (61.8)</b>	<b>\$ 1,984.2</b>

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows**  
**For the three months ended March 31, 2010**

	Principal Financial Group, Inc. Parent Only	Principal Life Insurance Company Only	Principal Financial Services, Inc. and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Operating activities</b>					
Net cash provided by (used in) operating activities	\$ (141.4)	\$ 768.2	\$ 36.9	\$ (10.5)	\$ 653.2
<b>Investing activities</b>					
Available-for-sale securities:					
Purchases		(2,000.0)	(204.6)	(23.9)	(2,228.5)
Sales	114.0	432.2	161.0		707.2
Maturities	0.7	747.5	80.3		828.5
Mortgage loans acquired or originated		(206.7)	(52.3)	39.9	(219.1)
Mortgage loans sold or repaid		394.5	97.9	(40.9)	451.5
Real estate acquired		(0.2)	(9.5)		(9.7)
Net purchases of property and equipment		(2.0)	(2.2)		(4.2)
Dividends received from unconsolidated entities	1.7	4.3	1.7	(7.7)	
Net change in other investments	5.8	(16.3)	5.3	17.5	12.3
Net cash provided by (used in) investing activities	122.2	(646.7)	77.6	(15.1)	(462.0)
<b>Financing activities</b>					
Issuance of common stock	8.3				8.3
Acquisition of treasury stock	(1.7)				(1.7)
Proceeds from financing element derivatives		16.6			16.6
Payments for financing element derivatives		(13.2)			(13.2)
Excess tax benefits from share-based payment arrangements		0.1	0.3		0.4
Dividends to preferred stockholders	(8.2)				(8.2)
Issuance of long-term debt			0.2		0.2
Principal repayments of long-term debt			(3.4)		(3.4)
			(0.9)	32.1	31.2

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Net proceeds from (repayments of) short-term borrowings					
Dividends paid to parent		(1.7)		(6.0)	7.7
Investment contract deposits		1,040.5		10.5	1,051.0
Investment contract withdrawals		(1,920.7)			(1,920.7)
Net increase in banking operation deposits					
				38.7	38.7
Other		(1.1)			(1.1)
Net cash provided by (used in) financing activities					
	(1.6)	(879.5)		39.4	39.8
Net increase (decrease) in cash and cash equivalents	(20.8)	(758.0)		153.9	14.2
Cash and cash equivalents at beginning of period					
	304.6	1,249.2		854.3	(167.7)
Cash and cash equivalents at end of period					
	\$ 283.8	\$ 491.2	\$ 1,008.2	\$ (153.5)	\$ 1,629.7

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)**

On June 11, 2008, our shelf registration statement was filed with the SEC and became effective. The shelf registration replaces the shelf registration that had been in effect since June 2004, as it was scheduled to expire in the fourth quarter of 2008. Under our current shelf registration, we have the ability to issue unsecured senior debt securities or subordinated debt securities, junior subordinated debt, preferred stock, common stock, warrants, depository shares, stock purchase contracts and stock purchase units of PFG, trust preferred securities of three subsidiary trusts and guarantees by PFG of these trust preferred securities. Our wholly owned subsidiary, PFS, may guarantee, fully and unconditionally or otherwise, our obligations with respect to any non-convertible securities, other than common stock, described in the shelf registration statement.

The following tables set forth condensed consolidating financial information of (i) PFG, (ii) PFS, (iii) Principal Life and all other direct and indirect subsidiaries of PFG on a combined basis and (iv) the eliminations necessary to arrive at the information for PFG on a consolidated basis as of March 31, 2011 and December 31, 2010, and for the three months ended March 31, 2011 and 2010.

In presenting the condensed consolidating financial statements, the equity method of accounting has been applied to (i) PFG's interest in PFS and (ii) PFS's interest in Principal Life and all other subsidiaries, where applicable, even though all such subsidiaries meet the requirements to be consolidated under U.S. GAAP. Earnings of subsidiaries are, therefore, reflected in the parent's investment and earnings. All intercompany balances and transactions, including elimination of the parent's investment in subsidiaries, between PFG, PFS and Principal Life and all other subsidiaries have been eliminated, as shown in the column Eliminations. These condensed consolidating financial statements should be read in conjunction with the consolidated financial statements. The financial information may not necessarily be indicative of results of operations, cash flows or financial position had the subsidiaries operated as independent entities.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Financial Position**  
**March 31, 2011**

	Principal Financial Group, Inc. Parent Only	Principal Financial Services, Inc. Only	Principal Life Insurance Company and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Assets</b>					
Fixed maturities, available-for-sale	\$	\$	\$ 48,305.5	\$	\$ 48,305.5
Fixed maturities, trading	190.1		816.2		1,006.3
Equity securities, available-for-sale			175.8		175.8
Equity securities, trading			389.7		389.7
Mortgage loans			10,900.0		10,900.0
Real estate			1,010.0		1,010.0
Policy loans			893.0		893.0
Investment in unconsolidated entities	10,464.2	10,478.1	764.9	(20,942.1)	765.1
Other investments	6.1	44.0	1,861.2		1,911.3
Cash and cash equivalents	871.8	638.0	1,439.0	(964.6)	1,984.2
Accrued investment income	0.4		675.2		675.6
Premiums due and other receivables	187.4		1,121.5	1.0	1,309.9
Deferred policy acquisition costs			3,549.9		3,549.9
Property and equipment			448.7		448.7
Goodwill			344.5		344.5
Other intangibles			829.3		829.3
Separate account assets			71,724.5		71,724.5
Other assets	14.7	11.4	1,311.3	(11.0)	1,326.4
<b>Total assets</b>	<b>\$ 11,734.7</b>	<b>\$ 11,171.5</b>	<b>\$ 146,560.2</b>	<b>\$ (21,916.7)</b>	<b>\$ 147,549.7</b>
<b>Liabilities</b>					
Contractholder funds	\$	\$	\$ 36,609.3	\$	\$ 36,609.3
Future policy benefits and claims			19,975.3		19,975.3
Other policyholder funds			607.5		607.5
Short-term debt		49.5	364.3	(307.0)	106.8
Long-term debt	1,351.7		228.1		1,579.8
Income taxes currently payable	(13.0)	(2.4)	9.8	9.2	3.6
Deferred income taxes	(19.6)	(5.4)	584.5	(16.8)	542.7
Separate account liabilities			71,724.5		71,724.5
Other liabilities	228.0	665.6	5,793.6	(659.8)	6,027.4
<b>Total liabilities</b>	<b>1,547.1</b>	<b>707.3</b>	<b>135,896.9</b>	<b>(974.4)</b>	<b>137,176.9</b>



Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

**Stockholders equity**

Series A preferred stock					
Series B preferred stock	<b>0.1</b>				<b>0.1</b>
Common stock	<b>4.5</b>		<b>17.8</b>	<b>(17.8)</b>	<b>4.5</b>
Additional paid-in capital	<b>9,580.1</b>	<b>8,135.1</b>	<b>7,541.9</b>	<b>(15,677.0)</b>	<b>9,580.1</b>
Retained earnings	<b>4,808.6</b>	<b>1,762.1</b>	<b>2,343.1</b>	<b>(4,105.2)</b>	<b>4,808.6</b>
Accumulated other comprehensive income	<b>525.5</b>	<b>567.0</b>	<b>577.3</b>	<b>(1,144.3)</b>	<b>525.5</b>
Treasury stock, at cost	<b>(4,731.2)</b>		<b>(2.0)</b>	<b>2.0</b>	<b>(4,731.2)</b>
Total stockholders equity attributable to PFG	<b>10,187.6</b>	<b>10,464.2</b>	<b>10,478.1</b>	<b>(20,942.3)</b>	<b>10,187.6</b>
Noncontrolling interest			<b>185.2</b>		<b>185.2</b>
Total stockholders equity	<b>10,187.6</b>	<b>10,464.2</b>	<b>10,663.3</b>	<b>(20,942.3)</b>	<b>10,372.8</b>
Total liabilities and stockholders equity	<b>\$ 11,734.7</b>	<b>\$ 11,171.5</b>	<b>\$ 146,560.2</b>	<b>\$ (21,916.7)</b>	<b>\$ 147,549.7</b>

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Financial Position**  
**December 31, 2010**

	Principal Financial Group, Inc. Parent Only	Principal Financial Services, Inc. Only	Principal Life Insurance Company and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Assets</b>					
Fixed maturities, available-for-sale	\$ 199.9	\$	\$ 48,436.4	\$	\$ 48,636.3
Fixed maturities, trading	274.9		845.4		1,120.3
Equity securities, available-for-sale			169.9		169.9
Equity securities, trading			316.9		316.9
Mortgage loans			11,125.1		11,125.1
Real estate			1,063.5		1,063.5
Policy loans			903.9		903.9
Investment in unconsolidated entities	10,195.1	10,209.0	735.8	(20,403.9)	736.0
Other investments	5.6	45.5	1,854.5		1,905.6
Cash and cash equivalents	370.9	519.7	1,821.7	(834.9)	1,877.4
Accrued investment income	0.8		665.3		666.1
Premiums due and other receivables			1,066.1	(3.1)	1,063.0
Deferred policy acquisition costs			3,529.8		3,529.8
Property and equipment			458.7		458.7
Goodwill			345.4		345.4
Other intangibles			834.6		834.6
Separate account assets			69,555.3		69,555.3
Other assets	13.6	9.8	1,302.4	(2.5)	1,323.3
<b>Total assets</b>	<b>\$ 11,060.8</b>	<b>\$ 10,784.0</b>	<b>\$ 145,030.7</b>	<b>\$ (21,244.4)</b>	<b>\$ 145,631.1</b>
<b>Liabilities</b>					
Contractholder funds	\$	\$	\$ 37,301.1	\$	\$ 37,301.1
Future policy benefits and claims			20,046.3		20,046.3
Other policyholder funds			592.2		592.2
Short-term debt		50.0	352.3	(294.4)	107.9
Long-term debt	1,351.7		232.0		1,583.7
Income taxes currently payable	(18.8)	(2.3)	11.6	15.7	6.2
Deferred income taxes	(21.6)	(8.7)	455.7	(15.5)	409.9
Separate account liabilities			69,555.3		69,555.3
Other liabilities	21.7	549.9	6,118.0	(546.1)	6,143.5
<b>Total liabilities</b>	<b>1,333.0</b>	<b>588.9</b>	<b>134,664.5</b>	<b>(840.3)</b>	<b>135,746.1</b>

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

**Stockholders equity**

Series A preferred stock							
Series B preferred stock	0.1					0.1	
Common stock	4.5			17.8	(17.8)	4.5	
Additional paid-in capital	9,563.8	8,334.0		7,730.0	(16,064.0)	9,563.8	
Retained earnings	4,612.3	1,546.3		2,142.4	(3,688.7)	4,612.3	
Accumulated other comprehensive income	272.4	314.8		320.8	(635.6)	272.4	
Treasury stock, at cost	(4,725.3)			(2.0)	2.0	(4,725.3)	
Total stockholders equity attributable to PFG	9,727.8	10,195.1		10,209.0	(20,404.1)	9,727.8	
Noncontrolling interest				157.2		157.2	
Total stockholders equity	9,727.8	10,195.1		10,366.2	(20,404.1)	9,885.0	
Total liabilities and stockholders equity	\$ 11,060.8	\$ 10,784.0	\$	145,030.7	\$ (21,244.4)	\$ 145,631.1	

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)****Condensed Consolidating Statements of Operations****For the three months ended March 31, 2011**

	Principal Financial Group, Inc. Parent Only	Principal Financial Services, Inc. Only	Principal Life Insurance Company and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Revenues</b>					
Premiums and other considerations	\$	\$	\$ 797.1	\$	\$ 797.1
Fees and other revenues			621.0	(0.2)	620.8
Net investment income (loss)	10.8	(1.3)	850.2	0.2	859.9
Net realized capital losses, excluding impairment losses on available-for-sale securities		(0.1)	(5.5)		(5.6)
Total other-than-temporary impairment losses on available-for-sale securities			(14.0)		(14.0)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified from other comprehensive income			(38.4)		(38.4)
Net impairment losses on available-for-sale securities			(52.4)		(52.4)
Net realized capital losses		(0.1)	(57.9)		(58.0)
Total revenues	10.8	(1.4)	2,210.4		2,219.8
<b>Expenses</b>					
Benefits, claims and settlement expenses			1,191.5		1,191.5
Dividends to policyholders			53.6		53.6
Operating expenses	29.2	0.3	661.7		691.2
Total expenses	29.2	0.3	1,906.8		1,936.3
Income (loss) before income taxes	(18.4)	(1.7)	303.6		283.5
Income taxes (benefits)	(7.0)	(2.6)	70.0		60.4
Equity in the net income of subsidiaries	215.9	215.0		(430.9)	
Net income	204.5	215.9	233.6	(430.9)	223.1
			18.6		18.6

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Net income attributable to  
noncontrolling interest

Net income attributable to PFG	<b>204.5</b>	<b>215.9</b>	<b>215.0</b>	<b>(430.9)</b>	<b>204.5</b>
Preferred stock dividends	<b>8.2</b>				<b>8.2</b>
Net income available to common stockholders	<b>\$ 196.3</b>	<b>\$ 215.9</b>	<b>\$ 215.0</b>	<b>\$ (430.9)</b>	<b>\$ 196.3</b>

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Operations**  
**For the three months ended March 31, 2010**

	Principal Financial Group, Inc. Parent Only	Principal Financial Services, Inc. Only	Principal Life Insurance Company and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Revenues</b>					
Premiums and other considerations	\$	\$	\$ 878.9	\$	\$ 878.9
Fees and other revenues			571.1	(3.5)	567.6
Net investment income (loss)	8.9	(1.1)	855.0	0.2	863.0
Net realized capital gains, excluding impairment losses on available-for-sale securities	0.7		33.0		33.7
Total other-than-temporary impairment losses on available-for-sale securities			(84.6)		(84.6)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to other comprehensive income			5.4		5.4
Net impairment losses on available-for-sale securities			(79.2)		(79.2)
Net realized capital gains (losses)	0.7		(46.2)		(45.5)
Total revenues	9.6	(1.1)	2,258.8	(3.3)	2,264.0
<b>Expenses</b>					
Benefits, claims and settlement expenses			1,275.3		1,275.3
Dividends to policyholders			56.5		56.5
Operating expenses	29.1	0.5	649.6	(3.3)	675.9
Total expenses	29.1	0.5	1,981.4	(3.3)	2,007.7
Income (loss) before income taxes	(19.5)	(1.6)	277.4		256.3
Income taxes (benefits)	(7.6)	(2.8)	63.1		52.7
Equity in the net income of subsidiaries	210.9	209.7		(420.6)	
Net income	199.0	210.9	214.3	(420.6)	203.6
Net income attributable to noncontrolling interest			4.6		4.6
Net income attributable to PFG	199.0	210.9	209.7	(420.6)	199.0
Preferred stock dividends	8.2				8.2
Net income available to common stockholders	\$ 190.8	\$ 210.9	\$ 209.7	\$ (420.6)	\$ 190.8



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)****Condensed Consolidating Statements of Cash Flows****For the three months ended March 31, 2011**

	Principal Financial Group, Inc. Parent Only	Principal Financial Services, Inc. Only	Principal Life Insurance Company and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Operating activities</b>					
Net cash provided by operating activities	\$ 99.9	\$ 114.0	\$ 1,098.7	\$ (117.1)	\$ 1,195.5
<b>Investing activities</b>					
Available-for-sale securities:					
Purchases	(4.4)		(1,662.0)		(1,666.4)
Sales	200.0		336.4		536.4
Maturities	4.4		1,721.2		1,725.6
Mortgage loans acquired or originated			(123.9)		(123.9)
Mortgage loans sold or repaid			323.7		323.7
Real estate acquired			(7.0)		(7.0)
Net purchases of property and equipment			(4.1)		(4.1)
Dividends and returns of capital received from unconsolidated entities	206.0	209.4		(415.4)	
Net change in other investments		1.4	(69.8)		(68.4)
Net cash provided by investing activities	406.0	210.8	514.5	(415.4)	715.9
<b>Financing activities</b>					
Issuance of common stock	9.1				9.1
Acquisition of treasury stock	(5.9)				(5.9)
Proceeds from financing element derivatives			19.4		19.4
Payments for financing element derivatives			(12.1)		(12.1)
Excess tax benefits from share-based payment arrangements			1.6		1.6
Dividends to preferred stockholders	(8.2)				(8.2)
Dividends and capital paid to parent		(206.0)	(209.4)	415.4	
Issuance of long-term debt			0.6		0.6



Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Principal repayments of long-term debt			(1.7)		(1.7)
Net proceeds from (repayments of) short-term borrowings	(0.5)		13.3	(12.6)	0.2
Investment contract deposits			893.3		893.3
Investment contract withdrawals			(2,674.2)		(2,674.2)
Net decrease in banking operation deposits			(25.8)		(25.8)
Other			(0.9)		(0.9)
Net cash used in financing activities	(5.0)	(206.5)	(1,995.9)	402.8	(1,804.6)
Net increase (decrease) in cash and cash equivalents	500.9	118.3	(382.7)	(129.7)	106.8
Cash and cash equivalents at beginning of year	370.9	519.7	1,821.7	(834.9)	1,877.4
Cash and cash equivalents at end of year	\$ 871.8	\$ 638.0	\$ 1,439.0	\$ (964.6)	\$ 1,984.2

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**March 31, 2011**  
**(Unaudited)**

**13. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows**  
**For the three months ended March 31, 2010**

	Principal Financial Group, Inc. Parent Only	Principal Financial Services, Inc. Only	Principal Life Insurance Company and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Operating activities</b>					
Net cash provided by (used in) operating activities	\$ (141.4)	\$ 49.4	\$ 793.1	\$ (47.9)	\$ 653.2
<b>Investing activities</b>					
Available-for-sale securities:					
Purchases			(2,228.5)		(2,228.5)
Sales	114.0		593.2		707.2
Maturities	0.7		827.8		828.5
Mortgage loans acquired or originated			(219.1)		(219.1)
Mortgage loans sold or repaid			451.5		451.5
Real estate acquired			(9.7)		(9.7)
Net purchases of property and equipment			(4.2)		(4.2)
Dividends received from unconsolidated entities	1.7	18.7		(20.4)	
Net change in other investments	5.8	7.0	11.1	(11.6)	12.3
Net cash provided by (used in) investing activities	122.2	25.7	(577.9)	(32.0)	(462.0)
<b>Financing activities</b>					
Issuance of common stock	8.3				8.3
Acquisition of treasury stock	(1.7)				(1.7)
Proceeds from financing element derivatives			16.6		16.6
Payments for financing element derivatives			(13.2)		(13.2)
Excess tax benefits from share-based payment arrangements			0.4		0.4
Dividends to preferred stockholders	(8.2)				(8.2)
Issuance of long-term debt			0.2		0.2
Principal repayments of long-term debt			(3.4)		(3.4)
Net proceeds from (repayments of) short-term borrowings		(2.0)	48.5	(15.3)	31.2

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Dividends paid to parent	(1.7)	(18.7)	20.4	
Investment contract deposits		1,051.0		1,051.0
Investment contract withdrawals		(1,920.7)		(1,920.7)
Net increase in banking operation deposits		38.7		38.7
Other		(1.1)		(1.1)
Net cash used in financing activities	(1.6)	(3.7)	(801.7)	5.1
Net increase (decrease) in cash and cash equivalents	(20.8)	71.4	(586.5)	(74.8)
Cash and cash equivalents at beginning of period	304.6	534.4	2,256.8	(855.4)
Cash and cash equivalents at end of period	\$ 283.8	\$ 605.8	\$ 1,670.3	\$ (930.2)
				\$ 1,629.7

**14. Subsequent Event**

On April 11, 2011, we announced the signing of a definitive agreement to acquire 100% of HSBC AFORE, S.A. de C.V., a Mexican pension business, from Grupo Financiero HSBC, S.A. de C.V. ( HSBC Bank ) for approximately \$198.0 million. In addition, we and HSBC Bank have agreed to establish a distribution arrangement for the distribution of Principal AFORE s products through HSBC Bank s extensive network in Mexico. The transaction, subject to regulatory approvals, is expected to close by early third quarter 2011.

Table of Contents

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following analysis discusses our financial condition as of March 31, 2011, compared with December 31, 2010, and our consolidated results of operations for the three months ended March 31, 2011 and 2010, prepared in conformity with U.S. GAAP. The discussion and analysis includes, where appropriate, factors that may affect our future financial performance. The discussion should be read in conjunction with our Form 10-K, for the year ended December 31, 2010, filed with the SEC and the unaudited consolidated financial statements and the related notes to the financial statements and the other financial information included elsewhere in this Form 10-Q.

**Forward-Looking Information**

Our narrative analysis below contains forward-looking statements intended to enhance the reader's ability to assess our future financial performance. Forward-looking statements include, but are not limited to, statements that represent our beliefs concerning future operations, strategies, financial results or other developments, and contain words and phrases such as anticipate, believe, plan, estimate, expect, intend, similar expressions. Forward-looking statements are made based upon management's current expectations and beliefs concerning future developments and their potential effects on us. Such forward-looking statements are not guarantees of future performance.

Actual results may differ materially from those included in the forward-looking statements as a result of risks and uncertainties including, but not limited to, the following: (1) adverse capital and credit market conditions may significantly affect our ability to meet liquidity needs, as well as our access to capital and cost of capital; (2) continued difficult conditions in the global capital markets and the economy generally may materially and adversely affect our business and results of operations; (3) continued volatility or further declines in the equity markets could reduce our assets under management (AUM) and may result in investors withdrawing from the markets or decreasing their rates of investment, all of which could reduce our revenues and net income; (4) changes in interest rates or credit spreads may adversely affect our results of operations, financial condition and liquidity, and our net income can vary from period-to-period; (5) our investment portfolio is subject to several risks that may diminish the value of our invested assets and the investment returns credited to customers, which could reduce our sales, revenues, AUM and net income; (6) our valuation of fixed maturities and equity securities may include methodologies, estimations and assumptions which are subject to differing interpretations and could result in changes to investment valuations that may materially adversely affect our results of operations or financial condition; (7) the determination of the amount of allowances and impairments taken on our investments requires estimations and assumptions which are subject to differing interpretations and could materially impact our results of operations or financial position; (8) gross unrealized losses may be realized or result in future impairments, resulting in a reduction in our net income; (9) competition from companies that may have greater financial resources, broader arrays of products, higher ratings and stronger financial performance may impair our ability to retain existing customers, attract new customers and maintain our profitability; (10) a downgrade in our financial strength or credit ratings may increase policy surrenders and withdrawals, reduce new sales and terminate relationships with distributors, impact existing liabilities and increase our cost of capital, any of which could adversely affect our profitability and financial condition; (11) our efforts to reduce the impact of interest rate changes on our profitability and retained earnings may not be effective; (12) if we are unable to attract and retain sales representatives and develop new distribution sources, sales of our products and services may be reduced; (13) our international businesses face political, legal, operational and other risks that could reduce our profitability in those businesses; (14) we may face losses if our actual experience differs significantly from our pricing and reserving assumptions; (15) our ability to pay stockholder dividends and meet our obligations may be constrained by the limitations on dividends Iowa insurance laws impose on Principal Life; (16) the pattern of amortizing our DPAC and other actuarial balances on our universal life-type insurance contracts, participating life insurance policies and certain investment contracts may change, impacting both the level of the asset and the timing of our net income; (17) we may need to fund deficiencies in our Closed Block assets that support participating ordinary life insurance policies that had a dividend scale in force at the time of Principal Life's 1998 conversion into a stock life insurance company; (18) a pandemic, terrorist attack or other catastrophic event could adversely affect our net income; (19) our reinsurers could default on their obligations or increase their rates, which could adversely impact our net income and profitability; (20) we face risks arising from acquisitions of businesses; (21) changes in laws, regulations or accounting standards may reduce our profitability; (22) a computer system failure or security breach could disrupt our business, damage our reputation and adversely impact our profitability; (23) results of litigation and regulatory investigations may affect our financial strength or reduce our profitability; (24) from time to time we may become subject to tax audits, tax litigation or similar proceedings, and as a result we may

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

owe additional taxes, interest and penalties in amounts that may be material; (25) fluctuations in foreign currency exchange rates could reduce our profitability; (26) applicable laws and our stockholder rights plan, certificate of incorporation and by-laws may discourage takeovers and business combinations that some stockholders might consider in their best interests and (27) our financial results may be adversely impacted by global climate changes.

Table of Contents

**Overview**

We provide financial products and services through the following reportable segments:

- Retirement and Investor Services, which consists of our asset accumulation operations that provide retirement savings and related investment products and services. We provide a comprehensive portfolio of asset accumulation products and services to businesses and individuals in the U.S., with a concentration on small and medium-sized businesses. We offer to businesses products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans, nonqualified executive benefit plans and employee stock ownership plan consulting services. We also offer annuities, mutual funds and bank products and services to the employees of our business customers and other individuals.
- Principal Global Investors, which consists of our asset management operations, offers an extensive range of equity, fixed income and real estate investments as well as specialized overlay and advisory services to institutional investors.
- Principal International, which offers retirement products and services, annuities, mutual funds, institutional asset management and life insurance accumulation products through operations in Brazil, Chile, China, Hong Kong SAR, India, Indonesia, Malaysia, Mexico, Singapore and Thailand.
- U.S. Insurance Solutions, which provides individual life insurance as well as specialty benefits in the U.S. Our individual life insurance products include universal and variable universal life insurance and traditional life insurance. Our specialty benefit products include group dental and vision insurance, individual and group disability insurance and group life insurance. Effective January 1, 2011, wellness services and fee-for-service claims administration transitioned to the Specialty Benefits division from the Corporate segment.
- Corporate, which manages the assets representing capital that has not been allocated to any other segment. Financial results of the Corporate segment primarily reflect our financing activities (including interest expense and preferred stock dividends), income on capital not allocated to other segments, inter-segment eliminations, income tax risks and certain income, expenses and other after-tax adjustments not allocated to the segments based on the nature of such items.

**Recent Events**

*Finisterre Capital LLP and Finisterre Holdings Limited*

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

On April 18, 2011, we announced the signing of a definitive agreement to acquire a majority stake in Finisterre Capital LLP and Finisterre Holdings Limited, (together Finisterre Capital), an emerging markets debt investor based in London. Finisterre Capital has approximately \$1.6 billion in AUM. The initial payment for the majority stake will be \$84.6 million, with a possible additional contingent payment of up to \$30.0 million in 2013, dependent upon performance targets. Finisterre Capital will be accounted for on the equity method within the Principal Global Investors segment. The transaction, subject to regulatory approval, is expected to close by early third quarter 2011.

### *HSBC AFORE, S.A. de C.V.*

On April 11, 2011, we announced the signing of a definitive agreement to acquire 100% of HSBC AFORE, S.A. de C.V., a Mexican pension business, from HSBC Bank for approximately \$198.0 million. In addition, we and HSBC Bank have agreed to establish a distribution arrangement for the distribution of Principal AFORE's products through HSBC Bank's extensive network in Mexico. The transaction, subject to regulatory approvals, is expected to close by early third quarter 2011.

### *Catalyst Health Solutions, Inc.*

In early April 2011, we sold a portion of our interest in Catalyst Health Solutions, Inc., which is accounted for on the equity method. The approximate \$46.0 million after-tax gain will be reported as a net realized capital gain in the second quarter of 2011 within the Corporate segment and will, therefore, be excluded from operating earnings. The remaining portion of the investment will continue to be accounted for as an equity method investment.

Table of Contents

**Transactions Affecting Comparability of Results of Operations**

***Group Medical Insurance Business***

On September 30, 2010, we announced our decision to exit the group medical insurance business (insured and administrative services only) and entered into an agreement with United Healthcare Services, Inc. to renew group medical insurance coverage for our customers as the business transitions. The exiting of the group medical insurance business does not yet qualify for discontinued operations treatment under U.S. GAAP. Therefore, the results of operations for the group medical insurance business are still included in our consolidated income from continuing operations.

With the exception of corporate overhead, amounts related to our group medical insurance business previously included in segment operating earnings have been removed from operating earnings for all periods presented and are reported as other after-tax adjustments. The operating revenues associated with our exited group medical insurance business were \$254.9 million and \$361.3 million for the three months ended March 31, 2011 and 2010, respectively. The other after-tax adjustments associated with the after-tax earnings of our exited group medical insurance business were \$17.1 million and \$33.9 million for the three months ended March 31, 2011 and 2010, respectively.

***Brasilprev Seguros e Previdencia S.A.***

On April 30, 2010, we signed definitive agreements with Banco do Brasil ( Banco ), including the Shareholders Agreement governing the operations of our pension joint venture, Brasilprev Seguros e Previdencia S.A. ( Brasilprev ). The agreements result in Brasilprev having, for 23 years, the exclusive right to distribute pension products within the Banco bank network and a reduction in our economic interest from 46% to 25%, which resulted in a \$72.1 million after-tax net realized capital gain in the second quarter of 2010. Brasilprev will continue to be jointly managed and reported as an equity method investment in our Principal International segment. Due to the reduction in our economic interest, we have seen a decline in our earnings from this operation.

**Fluctuations in Foreign Currency to U.S. Dollar Exchange Rates**

Fluctuations in foreign currency to U.S. dollar exchange rates for countries in which we have operations can affect reported financial results. In years when foreign currencies weaken against the U.S. dollar, translating foreign currencies into U.S. dollars results in fewer U.S. dollars to be reported. When foreign currencies strengthen, translating foreign currencies into U.S. dollars results in more U.S. dollars to be reported.

Foreign currency exchange rate fluctuations create variances in our financial statement line items but have not had a material impact on our consolidated financial results. The Principal International segment's operating earnings were positively impacted by \$2.2 million for the three months ended March 31, 2011 as a result of fluctuations in foreign currency to U.S. dollar exchange rates. For a discussion of our approaches to managing foreign currency exchange rate risk, see Item 3. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Risk.



**Stock-Based Compensation Plans**

For information related to our Stock-Based Compensation Plans, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 11, Stock-Based Compensation Plans.

Table of Contents

**Employee and Agent Benefits Expense**

The 2011 annual defined benefit pension expense for substantially all of our employees and certain agents was expected to be \$90.9 million pre-tax as of the beginning of the year, which is an \$18.6 million decrease from the 2010 pre-tax pension expense of \$109.5 million. This decrease is primarily due to actual asset returns in 2010 that were higher than expected asset returns. Pre-tax pension expense of \$22.4 million and \$27.6 million was reflected in the determination of net income for the three months ended March 31, 2011 and 2010, respectively. Due to the exit of the group medical insurance business, we have a curtailment associated with the benefits of the impacted employees that will be recognized as the impacted employees are terminated. As such, the expense will be measured quarterly during 2011 with updated asset values and potentially different discount rates. Based on the March 31, 2011, measurement, approximately \$19.6 million of pre-tax pension expense will be reflected in each of the following three quarters of 2011 for an expected total for the year of \$81.2 million as of March 31, 2011. The final expense for 2011 could be greater or less than \$81.2 million. The expected long-term return on plan assets used to develop the expense reflected in first quarter 2011 remained at the same 8.00% that was used to develop the 2010 expense, while the discount rate declined from 6.00% at December 31, 2009 to 5.65% as of December 31, 2010. As of March 31, 2011, the discount rate increased to 5.80%.

The 2011 annual other postretirement employee benefit ( OPEB ) plan expense (income) for retired employees was expected to be \$(53.2) million pre-tax as of the beginning of the year, which is a \$41.9 million difference from the 2010 pre-tax OPEB income of \$(11.3) million. This difference is primarily due to significant changes in plan design for the postretirement medical plan. As of January 1, 2011, the company-paid subsidy for pre-Medicare-eligible coverage is 40% and the cost of coverage for Medicare-eligible retirees (or their dependents) is no longer subsidized. In addition to the changes for individuals retiring on or after January 1, 2011, the method for determining the premium equivalent rate was changed to be solely based on retiree experience. Pre-tax expense (income) of \$(14.5) million and \$1.3 million was reflected in the determination of net income for the three months ended March 31, 2011 and 2010, respectively. Due to the exit of the group medical insurance business, we have a curtailment associated with the benefits of the impacted employees that will be recognized as the impacted employees are terminated. As such, the expense will be measured quarterly during 2011 with updated asset values and potentially different discount rates. Based on the March 31, 2011, measurement, approximately \$(13.5) million of pre-tax expense (income) will be reflected in each of the following three quarters of 2011 for an expected total for the year of \$(55.0) million as of March 31, 2011. The final expense (income) for 2011 could be greater or less than \$(55.0) million. The expected long-term return on plan assets used to develop the expense (income) reflected in first quarter 2011 remained at the same 7.30% that was used to develop the 2010 expense, while the discount rate declined from 6.00% at December 31, 2009 to 5.65% as of December 31, 2010. As of March 31, 2011, the discount rate increased to 5.80%.

**Healthcare Reform**

During the first quarter of 2010, federal legislation was enacted that reformed the healthcare system. Among the many changes, the enacted healthcare legislation eliminated the tax deductibility of retiree prescription drug expenses incurred after 2012, up to the Medicare Part D subsidy amount, which had been allowed to encourage employers to offer retiree drug coverage. We recognized a \$7.8 million negative impact to net income for the three months ended March 31, 2010, associated with the release of the portion of our deferred tax asset on accrued retiree prescription drug expenses related to our employees that will no longer be tax-deductible after December 31, 2012.

**Recent Accounting Changes**

For recent accounting changes, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 1, Nature of Operations and Significant Accounting Policies.



Table of Contents**Results of Operations**

The following table presents summary consolidated financial information for the periods indicated:

	For the three months ended March 31,			Increase (decrease)
	2011	2010 (in millions)		
<b>Revenues:</b>				
Premiums and other considerations	\$ 797.1	\$ 878.9	\$ (81.8)	
Fees and other revenues	620.8	567.6	53.2	
Net investment income	859.9	863.0	(3.1)	
Net realized capital gains (losses), excluding impairment losses on available-for-sale securities	(5.6)	33.7	(39.3)	
Total other-than-temporary impairment losses on available-for-sale securities	(14.0)	(84.6)	70.6	
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income	(38.4)	5.4	(43.8)	
Net impairment losses on available-for-sale securities	(52.4)	(79.2)	26.8	
Net realized capital losses	(58.0)	(45.5)	(12.5)	
Total revenues	2,219.8	2,264.0	(44.2)	
<b>Expenses:</b>				
Benefits, claims and settlement expenses	1,191.5	1,275.3	(83.8)	
Dividends to policyholders	53.6	56.5	(2.9)	
Operating expenses	691.2	675.9	15.3	
Total expenses	1,936.3	2,007.7	(71.4)	
Income before income taxes	283.5	256.3	27.2	
Income taxes	60.4	52.7	7.7	
Net income	223.1	203.6	19.5	
Net income attributable to noncontrolling interest	18.6	4.6	14.0	
Net income attributable to Principal Financial Group, Inc.	204.5	199.0	5.5	
Preferred stock dividends	8.2	8.2		
Net income available to common stockholders	\$ 196.3	\$ 190.8	\$ 5.5	

***Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010*****Net Income Available to Common Stockholders**

Net income available to common stockholders increased primarily due to higher profitability in our U.S. Insurance Solutions segment stemming from improved claims experience. This increase in net income available to common stockholders was partially offset by lower earnings in our Principal International segment primarily due to lower earnings in our equity method investment in Brazil as a result of the reduction in our economic interest and higher present value of future profits ( PVFP ) and DPAC amortization resulting from net unlocking and true-up adjustments in Mexico.

**Total Revenues**

Premiums decreased \$102.9 million for the Corporate segment primarily due to a reduction in average covered medical members in our exited group medical insurance business. Partially offsetting this decrease was an \$8.9 million increase in Retirement and Investor Services segment premiums primarily due to an increase in sales of annuities with life contingencies within our individual annuities business.

Fees increased \$21.4 million for our Retirement and Investor Services segment primarily due to higher fee income stemming from an increase in average account values as a result of continuing improvement in the equity market. In addition, fees increased \$20.4 million for our U.S. Insurance Solutions segment primarily due to growth in the universal life and variable universal life lines of business. Furthermore, fees increased \$11.2 million for our Principal Global Investors segment primarily due to higher fee revenues driven by an increase in average AUM.

Table of Contents

Net investment income decreased primarily due to a decrease in average invested assets and cash, excluding the fair value adjustment associated with fixed maturities and equity securities, primarily due to our decision to scale back our investment only business. This decrease was partially offset by higher inflation-based investment returns on average invested assets and cash as a result of higher inflation in Chile. For additional information, see Investments Investment Results.

Net realized capital gains (losses) can be volatile due to other than temporary impairments of invested assets, mark-to market adjustments of certain invested assets and our decision to sell invested assets. Net realized capital losses increased primarily due to mark-to-market losses versus gains on derivative activities, which were partially offset by lower net impairment losses on fixed maturities, available-for-sale. For additional information, see Investments Investment Results.

**Total Expenses**

Benefits, claims and settlement expenses decreased \$58.6 million for the Corporate segment primarily due to a reduction in average covered medical members in our exited group medical insurance business. In addition, Retirement and Investor Services segment benefits, claims and settlement expenses decreased \$39.8 million in our investment only business primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates and a decline in average account values, which resulted from our decision to scale back this business. Partially offsetting these decreases was a \$21.8 million increase for the Principal International segment, primarily due to higher inflation-based interest crediting rates to customers in Chile and the strengthening of the Chilean peso against the U.S. dollar.

U.S. Insurance Solutions operating expenses increased \$22.0 million, primarily due to higher DPAC amortization as a result of improved claims experience, additional operating expenses resulting from the transition of the wellness and fee-for-service claims administration businesses to this segment in 2011 and an increase in sales-related expenses on our group products that we do not defer. Operating expenses also increased \$12.7 million for the Principal International segment primarily due to higher PVFP and DPAC amortization resulting from net unlocking and true-up adjustments in Mexico, the strengthening of the Latin America currencies against the U.S. dollar and higher compensation expenses across the segment. Partially offsetting these increases was a \$21.0 million decrease for the Corporate segment primarily due to lower staff related costs in our exited group medical insurance business.

**Income Taxes**

The effective income tax rate was 21% for both the three months ended March 31, 2011 and 2010. The effective income tax rate for the three months ended March 31, 2011, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received, taxes on our share of earnings generated from equity method investments reflected in net investment income, and the inclusion of income attributable to noncontrolling interest in income before income taxes with no corresponding change in income taxes reported by us as the controlling interest. The effective income tax rate for the three months ended March 31, 2010, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received and taxes on our share of earnings generated from equity method investments reflected in net investment income.

**Results of Operations by Segment**

For results of operations by segment see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 10, Segment Information.

**Retirement and Investor Services Segment**

***Retirement and Investor Services Segment Summary Financial Data***

Account values are a key indicator of earnings growth for the segment, as account values are the base by which the segment generates its fee and spread-based profits. Net cash flow and market performance are the two main drivers of account value growth. Net cash flow reflects the segment's ability to attract and retain client deposits. Market performance reflects not only the equity market performance, but also the investment performance of fixed income investments supporting our spread business. The percentage growth in earnings of the segment should generally track the percentage growth in account values. This trend may vary due to changes in business and/or product mix.

Table of Contents

The following table presents the Retirement and Investor Services account value rollforward for the periods indicated:

	For the three months ended March 31,	
	2011	2010
	(in billions)	
Account values, beginning of period	\$ 178.3	\$ 163.9
Net cash flow (1)	0.3	0.1
Credited investment performance	6.0	5.2
Other		(0.4)
Account values, end of period	\$ 184.6	\$ 168.8

(1) Includes net cash flow of \$(0.8) and \$(0.7) billion for the three months ended March 31, 2011 and 2010, respectively, resulting from the decision to scale back our investment only business.

The following table presents certain summary financial data relating to the Retirement and Investor Services segment for the periods indicated:

	For the three months ended March 31,		Increase (decrease)
	2011	2010	
	(in millions)		
Operating revenues:			
Premiums and other considerations	\$ 73.8	\$ 64.9	\$ 8.9
Fees and other revenues	363.0	341.6	21.4
Net investment income	581.0	606.2	(25.2)
Total operating revenues	1,017.8	1,012.7	5.1
Expenses:			
Benefits, claims and settlement expenses, including dividends to policyholders	481.8	514.0	(32.2)
Operating expenses	325.0	297.4	27.6
Total expenses	806.8	811.4	(4.6)
Operating earnings before income taxes	211.0	201.3	9.7
Income taxes	51.7	44.3	7.4
Operating earnings	\$ 159.3	\$ 157.0	\$ 2.3

*Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010***Operating Earnings**

Operating earnings increased \$6.5 million in our individual annuities business due to growth in this block of business, higher investment yields and an increase in prepayment fee income. In addition, operating earnings increased \$2.1 million in our full service payout business primarily due to higher investment yields and an increase in prepayment fee income. Furthermore, operating earnings increased \$1.8 million in our Principal Funds business primarily due to higher fees stemming from an increase in average account values, which resulted from continuing



improvement in the equity market. Partially offsetting the increase in operating earnings was a \$7.8 million decrease in our investment only business primarily due to a decrease in fees, which stem from the early extinguishment of medium term notes in 2010 with no corresponding experience in 2011 and a decline in account values stemming from negative net cash flow as the pace of contractual maturities remains higher than the amount of new deposits.

### **Operating Revenues**

Premiums increased \$16.8 million in our individual annuities business primarily due to an increase in sales of annuities with life contingencies stemming from expanding opportunities with our bank distribution partners. Partially offsetting the increase in premiums was a \$7.9 million decrease in our full service payout business primarily due to a decrease in sales of single premium group annuities with life contingencies. The single premium product, which is typically used to fund defined benefit plan terminations, can generate large premiums from very few customers and therefore tends to vary from period to period.

Table of Contents

Fees increased \$15.2 million and \$12.4 million in our Principal Funds and full service accumulation businesses, respectively, primarily due to higher fee income stemming from an increase in average account values as a result of continuing improvement in the equity market. Partially offsetting the increase in fees was an \$8.4 million decrease in our investment only business primarily due to a decrease in fees, which stem from the early extinguishment of medium term notes in 2010 with no corresponding experience in 2011 and a decline in account values stemming from negative net cash flow as the pace of contractual maturities remains higher than the amount of new deposits.

Net investment income decreased primarily due to a decrease in average invested assets, excluding the fair value adjustment associated with fixed maturities and equity securities, resulting from our decision to scale back our investment only business.

**Total Expenses**

Benefits, claims and settlement expenses decreased \$28.2 million in our investment only business primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates and a decline in average account values, which primarily resulted from our decision to scale back this business. In addition, benefits, claims and settlement expenses decreased \$10.4 million in our full service payout business primarily due to a decrease in change in reserves resulting from a decrease in sales of single premium group annuities with life contingencies. Furthermore, benefits, claims and settlement expenses decreased \$10.3 million in our full service accumulation business primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates. Partially offsetting the decrease in benefits, claims and settlement expenses was a \$16.6 million increase in our individual annuities business primarily due to an increase in change of reserves resulting from higher sales of annuities with life contingencies and continued growth in the block of business.

Operating expenses in our full service accumulation business increased \$16.6 million primarily due to an increase in non-deferrable commission expense resulting from an increase in average account values and an increase in DPAC amortization expense resulting from more favorable DPAC true-ups in 2010. In addition, operating expenses increased \$12.4 million in our Principal Funds business primarily due to higher distribution expenses resulting from an increase in sales and average account values.

**Income Taxes**

The effective income tax rates for the segment were 25% and 22% for the three months ended March 31, 2011 and 2010, respectively. The effective income tax rates were lower than the U.S. statutory rate primarily as a result of income tax deductions allowed for corporate dividends received and the interest exclusion from taxable income. The effective income tax rate increased to 25% from 22% for the three months ended March 31, 2011 and 2010, respectively, primarily due to a favorable true-up for corporate dividends received in the first quarter of 2010 and an increase in operating earnings before income taxes with no proportionate change in permanent tax differences.

**Principal Global Investors Segment**

*Principal Global Investors Segment Summary Financial Data*

AUM is a key indicator of earnings growth for our Principal Global Investors segment, as AUM is the base by which we generate revenues. Net cash flow and market performance are the two main drivers of AUM growth. Net cash flow reflects our ability to attract and retain client deposits. Market performance reflects equity, fixed income and real estate market performance. The percentage growth in earnings of the segment will generally track with the percentage growth in AUM. This trend may vary due to changes in business and/or product mix.

Table of Contents

The following table presents the AUM rollforward for assets managed by Principal Global Investors for the periods indicated:

	For the three months ended March 31,			
	2011	(in billions)		2010
AUM, beginning of period	\$	220.1	\$	205.3
Net cash flow (1)		(3.9)		(1.9)
Investment performance		7.1		6.9
Other		(0.4)		1.2
AUM, end of period	\$	222.9	\$	211.5

(1) Includes net cash flow of \$(0.8) billion and \$(0.7) billion for the three months ended March 31, 2011 and 2010, respectively, resulting from the Retirement and Investor Services segment's decision to scale back its investment only business.

The following table presents certain summary financial data relating to the Principal Global Investors segment for the periods indicated:

	For the three months ended March 31,			Increase (decrease)		
	2011	2010 (in millions)				
<b>Operating revenues:</b>						
Fees and other revenues	\$	121.5	\$	110.3	\$	11.2
Net investment income		3.8		3.5		0.3
Total operating revenues		125.3		113.8		11.5
<b>Expenses:</b>						
Total expenses		99.0		93.9		5.1
Operating earnings before income taxes and noncontrolling interest		26.3		19.9		6.4
Income taxes		8.6		7.4		1.2
Operating earnings attributable to noncontrolling interest		1.1		0.5		0.6
Operating earnings	\$	16.6	\$	12.0	\$	4.6

***Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010*****Operating Earnings**

Operating earnings increased primarily due to higher fee revenues driven by an increase in average AUM, which was partially offset by higher staff related costs resulting from higher compensation expense.

**Income Taxes**

The effective income tax rates for the segment were 33% and 37% for the three months ended March 31, 2011 and 2010, respectively. The effective income tax rate for the three months ended March 31, 2011, was lower than the U.S. statutory rate, primarily due to the inclusion of income attributable to noncontrolling interest in operating earnings before income taxes with no corresponding change in income taxes reported by us as the controlling interest. The effective income tax rate for the three months ended March 31, 2010, was higher than the U.S. statutory rate, primarily due to an increase in state income tax expense. The effective income tax rate decreased to 33% from 37% for the three months ended March 31, 2011 and 2010, respectively, due to the reduction of taxes on foreign entities; employee compensation expenses and state income tax expense.

Table of Contents**Principal International Segment***Principal International Segment Summary Financial Data*

AUM is a key indicator of earnings growth for the segment, as AUM is the base by which we can generate local currency profits. Net customer cash flow and market performance are the two main drivers of local currency AUM growth. Net customer cash flow reflects our ability to attract and retain client deposits. Market performance reflects the investment returns on our underlying AUM. The percentage growth or decline in the earnings of our Principal International segment will generally track with the percentage growth or decline in AUM. This trend may vary due to changes in business and/or product mix. Our financial results are also impacted by fluctuations of the foreign currency to U.S. dollar exchange rates for the countries in which we have business. AUM of our foreign subsidiaries is translated into U.S. dollar equivalents at the end of the reporting period using the spot foreign exchange rates. Revenue and expenses for our foreign subsidiaries are translated into U.S. dollar equivalents at the average foreign exchange rates for the reporting period.

The following table presents the Principal International segment AUM rollforward for the periods indicated:

	For the three months ended March 31,		
	2011	2010	
	(in billions)		
AUM, beginning of period	\$	45.8	\$ 34.6
Net cash flow		1.3	0.4
Investment performance		0.6	0.8
Effect of exchange rates		1.0	
Other		(0.2)	(0.1)
AUM, end of period	\$	48.5	\$ 35.7

The following table presents certain summary financial data of the Principal International segment for the periods indicated:

	For the three months ended March 31,		Increase
	2011	2010	(decrease)
	(in millions)		
Operating revenues:			
Premiums and other considerations	\$ 66.8	\$ 59.1	\$ 7.7
Fees and other revenues	37.3	32.7	4.6
Net investment income	102.1	89.3	12.8
Total operating revenues	206.2	181.1	25.1
Expenses:			
Benefits, claims and settlement expenses	132.5	110.4	22.1
Operating expenses	43.9	32.1	11.8
Total expenses	176.4	142.5	33.9
Operating earnings before income taxes	29.8	38.6	(8.8)
Income taxes	1.3	0.5	0.8
Operating earnings attributable to noncontrolling interest		0.2	(0.2)

Operating earnings	\$	28.5	\$	37.9	\$	(9.4)
--------------------	----	------	----	------	----	-------

*Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010*

**Operating Earnings**

Operating earnings decreased primarily due to lower earnings in our equity method investment in Brazil as a result of the reduction in our economic interest and higher PVFP and DPAC amortization resulting from net unlocking and true-up adjustments in Mexico. These decreases were partially offset by higher fees driven by higher average AUM as a result of net customer cash flows and local market performance and the strengthening of the Latin American currencies against the U.S. dollar.

Table of Contents

**Operating Revenues**

Premiums increased \$7.7 million in Chile primarily due to the strengthening of the Chilean peso against the U.S. dollar and higher sales of single premium annuities with life contingencies.

Fees and other revenues increased primarily due to higher investment management fees in Chile, Hong Kong and Mexico driven by higher average AUM as a result of market performance and net customer cash flows and the strengthening of the Latin American currencies against the U.S. dollar.

Net investment income increased primarily due to higher inflation-based investment returns on average invested assets and cash as a result of higher inflation in Chile.

**Total Expenses**

Benefits, claims and settlement expenses increased \$24.7 million in Chile primarily due to higher inflation-based interest crediting rates to customers and the strengthening of the Chilean peso against the U.S. dollar.

Operating expenses increased primarily due to higher PVFP and DPAC amortization resulting from net unlocking and true-up adjustments in Mexico, the strengthening of the Latin America currencies against the U.S. dollar, higher compensation expenses across the segment and higher legal expenses primarily in our Brazilian holding company.

**Income Taxes**

The effective income tax rates for the segment were 4% and 1% for the three months ended March 31, 2011 and 2010, respectively. The effective income tax rates were lower than the U.S. statutory rate primarily due to taxes on our share of earnings generated from our equity method investments. Specifically, our share of earnings generated from equity method investments, net of foreign taxes incurred, are reported within net investment income whereas any residual U.S. tax expense or benefit related to equity method investments is reported in income taxes. Lower tax rates of foreign jurisdictions also contributed to the lower effective income tax rates.

**U.S. Insurance Solutions Segment**

*Individual Life Insurance Trends*



Our life insurance premiums are influenced by both economic and industry trends. In addition, we continue to shift our marketing emphasis to universal life insurance products from traditional life insurance products. Due to this shift in marketing emphasis, premiums related to our traditional life insurance products have declined, while fee revenues from our universal and variable universal life insurance products have grown.

The following table provides a summary of our individual universal and variable universal life insurance fee revenues and our individual traditional life insurance premiums for the periods indicated:

	For the three months ended March 31,	
	2011	2010
	(in millions)	
Universal and variable universal life insurance fee revenue	\$ 114.8	\$ 96.5
Traditional life insurance premiums	124.7	130.0

***Specialty Benefits Insurance Trends***

Premium and fees in our specialty benefits insurance business increased in 2011 due to solid sales and retention along with the transition of wellness and fee-for-service claims administration businesses to this division.

Table of Contents

The following table provides a summary of our specialty benefits insurance premium and fees for the periods indicated:

	For the three months ended March 31,	
	2011	2010
	(in millions)	
Premium and fees:		
Group dental and vision insurance	\$ 135.2	\$ 127.8
Group life insurance	80.1	79.2
Group disability insurance	68.3	65.1
Individual disability insurance	52.2	47.5
Wellness (1)	2.6	

(1) For three months ended March 31, 2010, wellness fees were reported in the Corporate segment.

*U.S. Insurance Solutions Segment Summary Financial Data*

There are several key indicators for earnings growth in our U.S. Insurance Solutions business. The ability of our distribution channels to generate new sales and retain existing business drives growth in our block of business, premium revenue and fee revenues. Our earnings growth also depends on our ability to price our products at a level that enables us to earn a margin over the cost of providing benefits and the expense of acquiring and administering those products. Factors impacting pricing decisions include competitive conditions, persistency, our ability to assess and manage trends in mortality and morbidity and our ability to manage operating expenses.

The following table presents certain summary financial data relating to the U.S. Insurance Solutions segment for the periods indicated:

	For the three months ended March 31,		Increase (decrease)
	2011	2010	
	(in millions)		
Operating revenues:			
Premiums and other considerations	\$ 428.6	\$ 424.1	\$ 4.5
Fees and other revenues	128.6	106.3	22.3
Net investment income	174.0	161.7	12.3
Total operating revenues	731.2	692.1	39.1
Expenses:			
Benefits, claims and settlement expenses	408.0	418.6	(10.6)
Dividends to policyholders	53.1	56.1	(3.0)
Operating expenses	182.7	152.8	29.9
Total expenses	643.8	627.5	16.3
Operating earnings before income taxes	87.4	64.6	22.8
Income taxes	27.9	20.5	7.4
Operating earnings	\$ 59.5	\$ 44.1	\$ 15.4

*Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010*

**Operating Earnings**

Operating earnings increased \$9.4 million in our specialty benefits insurance business due to improved claims experience and higher net investment income. Operating earnings increased \$6.0 million in our individual life insurance business primarily due to improved mortality experience in our universal life and variable universal life lines of business.

**Operating Revenues**

Premiums increased \$15.3 million in our specialty benefits insurance business due to strong sales and stable lapses. Premiums decreased \$10.8 million in our individual life insurance business primarily due to the expected continued decline from the decreasing block of traditional life insurance business.

Table of Contents

Fees and other revenues increased \$18.8 million in our individual life insurance business due to growth in the universal life and variable universal life lines of business.

Net investment income increased primarily due to an increase in average invested assets.

**Total Expenses**

Benefits, claims and settlement expenses decreased \$11.4 million in our individual life insurance business as a result of improved mortality experience.

Operating expenses increased \$18.5 million in our individual life insurance business primarily related to higher DPAC amortization as a result of improved claims experience. Operating expenses increased \$11.4 million in our specialty benefits insurance business primarily due to the transition of wellness and fee-for-service claim administration businesses to this division and an increase in sales-related expenses on our group products that we do not defer.

**Income Taxes**

The effective income tax rate for the segment was 32% for both the three months ended March 31, 2011 and 2010. The effective income tax rate was lower than the U.S. statutory rate as a result of the interest exclusion from taxable income and income tax deductions allowed for corporate dividends received.

**Corporate Segment**

*Corporate Segment Summary Financial Data*

The following table presents certain summary financial data relating to the Corporate segment for the periods indicated:

	<b>For the three months ended March 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>Increase</b>
		<b>(in millions)</b>	<b>(decrease)</b>
Operating revenues:			

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Total operating revenues	\$	(33.8)	\$	(27.2)	\$	(6.6)
Expenses:						
Total expenses		2.1		9.2		(7.1)
Operating losses before income taxes, preferred stock dividends and noncontrolling interest		(35.9)		(36.4)		0.5
Income tax benefits		(12.0)		(14.9)		2.9
Preferred stock dividends		8.2		8.2		
Operating loss attributable to noncontrolling interest				(0.1)		0.1
Operating losses	\$	(32.1)	\$	(29.6)	\$	(2.5)

*Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010*

**Operating Losses**

Operating losses increased primarily due to an increase in state income taxes.

**Operating revenues**

Operating revenues decreased due to an increase in inter-segment eliminations included in this segment, which was offset by a corresponding change in total expenses.

**Total Expenses**

Total expenses decreased due to an increase in inter-segment eliminations included in this segment, which was offset by a corresponding change in operating revenues.

Table of Contents

**Income Taxes**

Income tax benefits decreased primarily due to an increase in state income taxes.

**Liquidity and Capital Resources**

Liquidity and capital resources represent the overall strength of a company and its ability to generate strong cash flows, borrow funds at a competitive rate and raise new capital to meet operating and growth needs. Our legal entity structure has an impact on our ability to meet cash flow needs as an organization. Following is a simplified organizational structure.

Our liquidity requirements have been and will continue to be met by funds from consolidated operations as well as the issuance of commercial paper, common stock, debt or other capital securities and borrowings from credit facilities. We believe that cash flows from these sources are sufficient to satisfy the current liquidity requirements of our operations, including reasonably foreseeable contingencies.

We maintain a level of cash and securities which, combined with expected cash inflows from investments and operations, is believed to be adequate to meet anticipated short-term and long-term payment obligations. We will continue our prudent capital management practice of regularly exploring options available to us to maximize capital flexibility, including accessing the capital markets and careful attention to and management of expenses.

As of March 31, 2011, approximately \$11.1 billion, or 98%, of our institutional guaranteed investment contracts and funding agreements cannot be redeemed by contractholders prior to maturity. Our life insurance and annuity liabilities contain provisions limiting early surrenders. Due to past market conditions, we had maintained a historically high position of cash and cash equivalent holdings. As market conditions improve we have been reducing our cash and cash equivalent holdings. Our liquidity is also supported by a portfolio of U.S. government and agency and residential pass-through government-backed securities, of which we held \$3.9 billion as of March 31, 2011, that may be utilized to bolster our liquidity position, as collateral for secured borrowing transactions with various third parties or by disposing of the securities in the open market.

if needed.

As of March 31, 2011 and December 31, 2010, we had short-term credit facilities with various financial institutions in an aggregate amount of \$737.8 million and \$719.8 million, respectively. As of March 31, 2011 and December 31, 2010, we had \$106.8 million and \$107.9 million, respectively, of outstanding borrowings related to our credit facilities, with \$26.5 million of assets pledged as support as of March 31, 2011. None of these credit arrangements, other than our commercial paper back-stop facility, are committed facilities. Due to the financial strength and the strong relationships we have with these providers, as well as the small size of these facilities, we are comfortable that there is a very low risk that the financial institutions would not be able to fund these facilities. As of both March 31, 2011 and December 31, 2010, our credit facilities include a \$579.0 million commercial paper program, of which \$49.5 million and \$50.0 million was outstanding as of March 31, 2011 and December 31, 2010, respectively. Our commercial paper program has a back-stop facility to provide 100% support for our commercial paper program, of which there were no outstanding balances as of March 31, 2011 and December 31, 2010. The back-stop facility is a five year facility that matures in June 2012. The facility is supported by fourteen banks, most if not all of which have other relationships with us. We have no reason to believe that our current providers would be unable or unwilling to fund the facility if necessary.

Table of Contents

**The Holding Companies: Principal Financial Group, Inc. and Principal Financial Services, Inc.** The principal sources of funds available to our parent holding company, PFG, to meet its obligations, including the payments of dividends on common stock, debt service and the repurchase of stock, are dividends from subsidiaries as well as its ability to borrow funds at competitive rates and raise capital to meet operating and growth needs. Dividends from Principal Life, our primary subsidiary, are limited by Iowa law. Under Iowa laws, Principal Life may pay dividends only from the earned surplus arising from its business and must receive the prior approval of the Insurance Commissioner of the State of Iowa ( the Commissioner ) to pay stockholder dividends or make any other distribution if such distributions would exceed certain statutory limitations. Iowa law gives the Commissioner discretion to disapprove requests for distributions in excess of these limits. In general, the current statutory limitations are the greater of (i) 10% of Principal Life's statutory policyholder surplus as of the previous year-end or (ii) the statutory net gain from operations from the previous calendar year. Based on these limitations, Principal Life could distribute approximately \$509.7 million in 2011. No dividends were paid as of March 31, 2011; however, on March 29, 2011, Principal Life distributed paid-in and contributed surplus in the amount of \$200.0 million to its parent company, which counts toward Principal Life's distribution capacity for the year.

**Operations.** Our primary consolidated cash flow sources are premiums from insurance products, pension and annuity deposits, asset management fee revenues, administrative services fee revenues, income from investments and proceeds from the sales or maturity of investments. Cash outflows consist primarily of payment of benefits to policyholders and beneficiaries, income and other taxes, current operating expenses, payment of dividends to policyholders, payments in connection with investments acquired, payments made to acquire subsidiaries, payments relating to policy and contract surrenders, withdrawals, policy loans, interest expense and repayment of short-term debt and long-term debt. Our investment strategies are generally intended to provide adequate funds to pay benefits without forced sales of investments. For a discussion of our investment objectives, strategies and a discussion of duration matching, see Investments as well as Item 3. Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk.

**Cash Flows.** Activity, as reported in our consolidated statements of cash flows, provides relevant information regarding our sources and uses of cash.

Net cash provided by operating activities was \$1,195.5 million and \$653.2 million for the three months ended March 31, 2011, and 2010, respectively. As an insurance business, we typically generate positive cash flows from operating activities, as premiums collected from our insurance products and income received from our investments exceed policy acquisition costs, benefits paid, redemptions and operating expenses. These positive cash flows are then invested to support the obligations of our insurance and investment products and required capital supporting these products. Our cash flows from operating activities are affected by the timing of premiums, fees and investment income received and benefits and expenses paid. The increase in cash provided by operating activities in 2011 compared to 2010 was primarily due to fluctuations in receivables and payables associated with the timing of settlement premiums and other considerations, increased cash flows from trading securities and sales of real estate.

Net cash provided by investing activities was \$715.9 million for the three months ended March 31, 2011 compared to net cash used in investing activities of \$462.0 million for the three months ended March 31, 2010. The increase in cash provided by investing activities in 2011 compared to 2010 was primarily the result of an increase in net sales and maturities of investments in 2011.

Net cash used in financing activities was \$1,804.6 million and \$801.9 million for the three months ended March 31, 2011, and 2010, respectively. The increase in cash used in financing activities was primarily due to an increase in net withdrawals of investment contracts, for which we have had net withdrawals in both 2011 and 2010 primarily due to our decision to scale back our investment only business.



## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

**Shelf Registration.** We currently have an effective shelf registration which allows us the ability to issue, in unlimited amounts, unsecured senior debt securities or subordinated debt securities, junior subordinated debt, preferred stock, common stock, warrants, depository shares, stock purchase contracts and stock purchase units of PFG, trust preferred securities of three subsidiary trusts and guarantees by PFG of these trust preferred securities. Our wholly owned subsidiary, PFS, may guarantee, fully and unconditionally or otherwise, our obligations with respect to any non-convertible securities, other than common stock, described in the shelf registration.

**Preferred Stock Dividend Restrictions and Payments.** The certificates of designation for the Series A and B Preferred Stock restrict the declaration of preferred dividends if we fail to meet specified capital adequacy, net income or stockholders' equity levels. As of March 31, 2011, we have no preferred dividend restrictions. The dividend payments on our preferred stock are not mandatory or cumulative, as our Board of Directors approves each quarterly dividend payment.

Table of Contents

**Short-Term Debt.** The components of short-term debt as of March 31, 2011, and December 31, 2010, were as follows:

	March 31, 2011	December 31, 2010
	(in millions)	
Commercial paper	\$ 49.5	\$ 50.0
Other recourse short-term debt	57.3	57.9
Total short-term debt	\$ 106.8	\$ 107.9

**Long-Term Debt.** As of March 31, 2011, there have been no significant changes to long-term debt since December 31, 2010.

**Stockholders' Equity.** For additional stockholders' equity information, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 8, Stockholders' Equity.

**Capitalization**

Our capital structure as of March 31, 2011, and December 31, 2010, consisted of debt and equity summarized as follows:

	March 31, 2011	December 31, 2010
	(in millions)	
<b>Debt:</b>		
Short-term debt	\$ 106.8	\$ 107.9
Long-term debt	1,579.8	1,583.7
Total debt	1,686.6	1,691.6
<b>Stockholders' equity:</b>		
Equity attributable to Principal Financial Group, Inc. excluding accumulated other comprehensive income	9,662.1	9,455.4
Total capitalization excluding accumulated other comprehensive income	\$ 11,348.7	\$ 11,147.0
Debt to equity excluding accumulated other comprehensive income	17%	18%
Debt to capitalization excluding accumulated other comprehensive income	15%	15%

As of March 31, 2011, we had \$1,040.0 million of excess capital in the holding companies, consisting of cash and highly liquid assets available for debt maturities, interest, preferred stock dividends and other holding company obligations. In addition, we continue to maintain sufficient capital levels in Principal Life based on our current financial strength ratings.

**Contractual Obligations and Contractual Commitments**

As of March 31, 2011, there have been no significant changes to contractual obligations and contractual commitments since December 31, 2010.

***Off-Balance Sheet Arrangements***

***Variable Interest Entities.*** We have relationships with various types of special purpose entities and other entities where we have a variable interest as described in Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 2, Variable Interest Entities.

***Guarantees and Indemnifications.*** As of March 31, 2011, there have been no significant changes to guarantees and indemnifications since December 31, 2010. For guarantee and indemnification information, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 7, Contingencies, Guarantees and Indemnifications under the caption, Guarantees and Indemnifications.

***Financial Strength Rating and Credit Ratings***

Our ratings are influenced by the relative ratings of our peers/competitors as well as many other factors including our operating and financial performance, asset quality, liquidity, asset/liability management, overall portfolio mix, financial leverage (i.e., debt), risk exposures, operating leverage, ratings and other factors.

Table of Contents

Nationally Recognized Statistical Rating Organizations ( NRSROs ) publish financial strength ratings on U.S. life insurance companies that are indicators of an insurance company's ability to meet contractholder and policyholder obligations. NRSROs also assign credit ratings on non-life insurance entities, such as PFG and PFS. Credit ratings are indicators of a debt issuer's ability to meet the terms of debt obligations in a timely manner, and are important factors in overall funding profile and ability to access external capital. Such ratings are not a recommendation to buy, sell or hold securities. Ratings are subject to revision or withdrawal at any time by the assigning NRSRO.

AM Best, Fitch, Moody's and Standard & Poor's maintain a stable outlook on the U.S. life insurance sector. Despite the stable outlook, there is still concern about the impact of economic conditions on earnings recovery, and potential impact on residential or commercial real estate related investments.

The following table summarizes our significant financial strength and debt ratings from the major independent rating organizations. The debt ratings shown are indicative ratings. Outstanding issuances are rated the same as indicative ratings unless otherwise noted. Actual ratings can differ from indicative ratings based on contractual terms.

	A.M. Best	Fitch	Standard & Poor's	Moody's
<b>Principal Financial Group</b>				
Senior Unsecured Debt (1)			BBB	Baa1
Preferred Stock (2)			BB+	Baa3
<b>Principal Financial Services</b>				
Senior Unsecured Debt			BBB	
Commercial Paper		F-1	A-2	P-2
<b>Principal Life Insurance Company</b>				
Insurer Financial Strength	A+	AA-	A	Aa3
Enterprise Risk Management Rating			Strong	
<b>Principal National Life Insurance Company</b>				
Insurer Financial Strength	A+	AA-	A	Aa3

(1) Moody's has rated Principal Financial Group's senior debt issuance A3

(2) S&P has rated Principal Financial Group's preferred stock issuance BB

**Fair Value Measurement**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three levels for disclosure purposes. The fair value hierarchy gives the highest priority (Level 1) to quoted prices in active markets for identical assets or liabilities and gives the lowest priority (Level 3) to unobservable inputs. An asset or liability's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation. See Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 9, Fair Value Measurements for further details, including a reconciliation of changes in Level 3 fair value measurements.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

As of March 31, 2011, 44% of our net assets (liabilities) were Level 1, 52% were Level 2 and 4% were Level 3. Excluding separate account assets as of March 31, 2011, 1% of our net assets (liabilities) were Level 1, 97% were Level 2 and 2% were Level 3.

As of December 31, 2010, 43% of our net assets (liabilities) were Level 1, 53% were Level 2 and 4% were Level 3. Excluding separate account assets as of December 31, 2010, 2% of our net assets (liabilities) were Level 1, 96% were Level 2 and 2% were Level 3.

### **Changes in Level 3 fair value measurements**

Net assets (liabilities) measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of March 31, 2011, were \$4,719.1 million as compared to \$4,691.4 million as of December 31, 2010. The increase is primarily related to gains on other invested assets and real estate included in net income in our separate account assets. These increases are partially offset by net sales of separate account assets and transfers out of Level 3 to Level 2 due to our obtaining prices from third party pricing vendors versus relying on broker quotes or internal pricing models for certain separate account long term bonds.

Table of Contents

Net assets (liabilities) measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of March 31, 2010, were \$5,352.8 million as compared to \$5,276.5 million as of December 31, 2009. The increase is primarily related to the implementation of new authoritative guidance related to the accounting for VIEs effective January 1, 2010. As a result of the new guidance, certain previously unconsolidated VIEs were consolidated and certain previously consolidated VIEs were deconsolidated. The fair value of the Level 3 assets and liabilities of the newly consolidated and deconsolidated VIEs is primarily included in fixed maturities, trading; other investments; derivative liabilities and other liabilities.

**Investments**

We had total consolidated assets as of March 31, 2011, of \$147.5 billion, of which \$65.4 billion were invested assets. The rest of our total consolidated assets are comprised primarily of separate account assets for which we do not bear investment risk. Because we generally do not bear any investment risk on assets held in separate accounts, the discussion and financial information below does not include such assets.

**Overall Composition of Invested Assets**

Invested assets as of March 31, 2011, were predominantly high quality and broadly diversified across asset class, individual credit, industry and geographic location. Asset allocation is determined based on cash flow and the risk/return requirements of our products. As shown in the following table, the major categories of invested assets are fixed maturities and commercial mortgage loans. The remainder is invested in residential mortgage loans, real estate, equity securities and other assets. In addition, policy loans are included in our invested assets.

	March 31, 2011		December 31, 2010	
	Carrying amount	% of total	Carrying amount	% of total
	(\$ in millions)			
Fixed maturities:				
Public	\$ 34,673.0	53%	\$ 35,426.8	54%
Private	14,638.8	22	14,329.8	22
Equity securities	565.5	1	486.8	1
Mortgage loans:				
Commercial	9,430.4	15	9,609.0	14
Residential	1,469.6	2	1,516.1	2
Real estate held for sale	68.7		51.9	
Real estate held for investment	941.3	2	1,011.6	2
Policy loans	893.0	1	903.9	1
Other investments	2,676.4	4	2,641.6	4
Total invested assets	65,356.7	100%	65,977.5	100%
Cash and cash equivalents	1,984.2		1,877.4	
Total invested assets and cash	\$ 67,340.9		\$ 67,854.9	

Table of Contents**Investment Results***Net Investment Income*

The following table presents the yield and investment income, excluding net realized capital gains and losses, for our invested assets for the periods indicated. We calculate annualized yields using a simple average of asset classes at the beginning and end of the reporting period. The yields for fixed maturities and equity securities are calculated using amortized cost and cost, respectively. All other yields are calculated using carrying amounts.

	For the three months ended, March 31				Increase (decrease)	
	Yield	2011 Amount	Yield	2010 Amount	Yield	2011 vs. 2010 Amount
	(\$ in millions)					
Fixed maturities	5.5%	\$ 667.0	5.6%	\$ 688.3	(0.1)%	\$ (21.3)
Equity securities	2.9	3.9	3.5	3.8	(0.6)	0.1
Mortgage loans - commercial	5.9	139.8	5.9	146.8		(7.0)
Mortgage loans - residential	5.6	20.9	4.5	19.2	1.1	1.7
Real Estate	11.0	28.6	3.8	9.8	7.2	18.8
Policy loans	6.4	14.5	7.0	15.8	(0.6)	(1.3)
Cash and cash equivalents	0.3	1.4	0.3	1.4		
Other investments	0.7	4.6	(0.1)	(0.5)	0.8	5.1
Total before investment expenses	5.3	880.7	5.2	884.6	0.1	(3.9)
Investment expenses	(0.1)	(20.8)	(0.1)	(21.6)		0.8
Net investment income	5.2%	\$ 859.9	5.1%	\$ 863.0	0.1%	\$ (3.1)

*Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010*

Net investment income decreased due to a decrease in average invested assets as the result of our decision to continue scaling back our investment only business. This decrease was primarily offset by gains on sales of equity real estate and higher inflation-based investment returns on average invested assets related to higher inflation in Chile during 2011 as compared to 2010.

*Net Realized Capital Gains (Losses)*

The following table presents the contributors to net realized capital gains and losses for our invested assets for the years indicated.

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

	For the three months ended, March 31			Increase (decrease) 2011 vs. 2010
	2011	2010 (in millions)		
Fixed maturities, available-for-sale - credit impairments (1)	\$ (50.2)	\$	(77.5)	\$ 27.3
Fixed maturities, available-for-sale - other	1.0		8.3	(7.3)
Fixed maturities, trading	(4.6)		10.5	(15.1)
Equity securities - credit impairments, net of recoveries	2.1		4.0	(1.9)
Derivatives and related hedge activities (2)	(25.2)		23.6	(48.8)
Commercial mortgages	(7.8)		(17.2)	9.4
Other gains	26.7		2.8	23.9
Net realized capital losses	\$ (58.0)	\$	(45.5)	\$ (12.5)

- 
- (1) Includes credit impairments as well as losses on sales of fixed maturities to reduce credit risk, net of realized credit recoveries on the sale of previously impaired securities. Credit gains on sales, excluding associated foreign currency fluctuations that are included in derivatives and related hedge activities, were a net gain of \$4.7 million and \$5.7 million for the three months ended March 31, 2011 and 2010, respectively.
- (2) Includes fixed maturities, available-for-sale impairment-related net gains of \$0.4 million for the three months ended March 31, 2011 which were hedged by derivatives reflected in this line. There were no fixed maturities available-for-sale impairment-related net gains in this line as of March 31, 2010.



Table of Contents

*Three Months Ended March 31, 2011 Compared to Three Months Ended March 31, 2010*

Net realized capital losses on fixed maturities, available-for-sale credit impairments decreased primarily due to lower impairments on commercial mortgage-backed and other asset-backed securities as a result of improved market conditions.

Net realized capital losses on fixed maturities, trading increased due to mark-to-market losses versus gains on these securities resulting from changes in credit spreads and interest rates.

Net realized capital losses on derivatives and related hedge activities increased due to increased losses on the GMWB embedded derivatives resulting from changes in the spread reflecting our own creditworthiness and losses versus gains on derivatives not designated as hedging instruments due to changes in interest and currency exchange rates.

Other net realized capital gains increased primarily due to higher equity market gains in 2011 relative to 2010.

**U.S. Investment Operations**

Of our invested assets, \$60.0 billion were held by our U.S. operations as of March 31, 2011. Our U.S. invested assets are managed primarily by our Principal Global Investors segment. Our primary investment objective is to maximize after-tax returns consistent with acceptable risk parameters. We seek to protect policyholders' benefits by optimizing the risk/return relationship on an ongoing basis, through asset/liability matching, reducing the credit risk, avoiding high levels of investments that may be redeemed by the issuer, maintaining sufficiently liquid investments and avoiding undue asset concentrations through diversification. We are exposed to two primary sources of investment risk:

- credit risk, relating to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest and
- interest rate risk, relating to the market price and/or cash flow variability associated with changes in market yield curves.

Our ability to manage credit risk is essential to our business and our profitability. We devote considerable resources to the credit analysis of each new investment. We manage credit risk through industry, issuer and asset class diversification. Our Investment Committee, appointed by our Board of Directors, is responsible for establishing all investment policies and approving or authorizing all investments, except the Executive Committee of the Board must approve any investment transaction exceeding \$500.0 million. As of March 31, 2011, there are eleven members on the Investment Committee, one of whom is a member of our Board of Directors. The remaining members are senior management members representing various areas of our company.

We also seek to reduce call or prepayment risk arising from changes in interest rates in individual investments. We limit our exposure to investments that are prepayable without penalty prior to maturity at the option of the issuer and we require additional yield on these investments to compensate for the risk that the issuer will exercise such option. We assess option risk in all investments we make and, when we take that risk, we price for it accordingly.

Our Fixed Income Securities Committee, consisting of fixed income securities senior management members, approves the credit rating for the fixed maturities we purchase. Teams of security analysts, organized by industry, analyze and monitor these investments. In addition, we have teams who specialize in RMBS, CMBS, ABS, municipals and below investment grade securities. Our analysts monitor issuers held in the portfolio on a continuous basis with a formal review documented annually or more frequently if material events affect the issuer. The analysis includes both fundamental and technical factors. The fundamental analysis encompasses both quantitative and qualitative analysis of the issuer. The qualitative analysis includes an assessment of both accounting and management aggressiveness of the issuer. In addition, technical indicators such as stock price volatility and credit default swap levels are monitored.

Our Fixed Income Securities Committee also reviews private transactions on a continuous basis to assess the quality ratings of our privately placed investments. We regularly review our investments to determine whether we should re-rate them, employing the following criteria:

- material declines in the issuer's revenues or margins;
- significant management or organizational changes;

Table of Contents

- significant uncertainty regarding the issuer's industry;
- debt service coverage or cash flow ratios that fall below industry-specific thresholds;
- violation of financial covenants and
- other business factors that relate to the issuer.

A dedicated risk management team is responsible for centralized monitoring of the commercial mortgage loan portfolio. We apply a variety of strategies to minimize credit risk in our commercial mortgage loan portfolio. When considering the origination of new commercial mortgage loans, we review the cash flow fundamentals of the property, make a physical assessment of the underlying security, conduct a comprehensive market analysis and compare against industry lending practices. We use a proprietary risk rating model to evaluate all new and substantially all existing loans within the portfolio. The proprietary risk model is designed to stress projected cash flows under simulated economic and market downturns. Our lending guidelines are typically 65% or less loan-to-value ratio and a debt service coverage ratio of at least 1.5 times. We analyze investments outside of these guidelines based on cash flow quality, tenancy and other factors. The following table presents loan-to-value and debt service coverage ratios for our brick and mortar commercial mortgages, excluding Principal Global Investors segment mortgages:

	Weighted average loan-to-value ratio		Debt service coverage ratio	
	March 31, 2011	December 31, 2010	March 31, 2011	December 31, 2010
New mortgages	53%	44%	2.3x	3.5x
Entire mortgage portfolio	65%	66%	1.9x	1.8x

Our investment decisions and objectives are a function of the underlying risks and product profiles of each primary business operation. In addition, we diversify our product portfolio offerings to include products that contain features that will protect us against fluctuations in interest rates. Those features include adjustable crediting rates, policy surrender charges and market value adjustments on liquidations. For further information on our management of interest rate risk, see Item 3. Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk.

**Overall Composition of U.S. Invested Assets**

As shown in the following table, the major categories of U.S. invested assets are fixed maturities and commercial mortgage loans. The remainder is invested in other investments, real estate, residential mortgage loans and equity securities. In addition, policy loans are included in our invested assets. The following discussion analyzes the composition of U.S. invested assets, but excludes invested assets of the separate accounts.

March 31, 2011

December 31, 2010

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

	Carrying amount	% of total	Carrying amount	% of total
	(\$ in millions)			
<b>Fixed maturities:</b>				
Public	\$ 31,248.0	52%	\$ 31,956.6	53%
Private	14,638.8	24	14,329.8	24
Equity securities	500.6	1	424.1	1
<b>Mortgage loans:</b>				
Commercial	9,421.3	16	9,599.6	16
Residential	841.6	1	877.5	1
Real estate held for sale	58.5		41.6	
Real estate held for investment	940.4	2	1,010.7	2
Policy loans	868.9	2	879.7	1
Other investments	1,465.9	2	1,486.3	2
Total invested assets	59,984.0	100%	60,605.9	100%
Cash and cash equivalents	1,908.4		1,817.2	
Total invested assets and cash	\$ 61,892.4		\$ 62,423.1	

Table of Contents**Fixed Maturities**

Fixed maturities consist of publicly traded and privately placed bonds, asset-backed securities, redeemable preferred stock and certain nonredeemable preferred stock. Included in the privately placed category as of March 31, 2011 and December 31, 2010, were \$9.1 billion and \$8.7 billion, respectively, of securities subject to certain holding periods and resale restrictions pursuant to Rule 144A of the Securities Act of 1933. Fixed maturities include trading portfolios that support investment strategies that involve the active and frequent purchase and sale of fixed maturities. We held \$190.1 million and \$274.9 million of these trading securities as of March 31, 2011 and December 31, 2010, respectively.

Fixed maturities were diversified by category of issuer, as shown in the following table for the periods indicated.

	March 31, 2011		December 31, 2010	
	Carrying amount	% of total	Carrying amount	% of total
	(\$ in millions)			
U.S. government and agencies	\$ 628.8	1%	\$ 929.1	2%
States and political subdivisions	2,833.6	6	2,826.9	6
Non-U.S. governments	408.9	1	424.2	1
Corporate - public	18,932.8	41	19,201.2	41
Corporate - private	12,170.2	27	12,065.1	26
Residential mortgage-backed pass-through securities	3,260.0	7	3,379.5	7
Commercial mortgage-backed securities	3,988.1	9	3,847.3	9
Residential collateralized mortgage obligations	1,406.9	3	1,435.4	3
Asset-backed securities	2,257.5	5	2,177.7	5
Total fixed maturities	\$ 45,886.8	100%	\$ 46,286.4	100%

We believe that it is desirable to hold residential mortgage-backed pass-through securities due to their credit quality and liquidity as well as portfolio diversification characteristics. Our portfolio is comprised of Government National Mortgage Association, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation pass-through securities. In addition, our residential collateralized mortgage obligation portfolio offers structural features that allow cash flows to be matched to our liabilities.

CMBS provide varying levels of credit protection, diversification and reduced event risk depending on the securities owned and composition of the loan pool. CMBS are predominantly comprised of large pool securitizations that are diverse by property type, borrower and geographic dispersion. The risks to any CMBS deal are determined by the credit quality of the underlying loans and how those loans perform over time. Another key risk is the vintage of the underlying loans and the state of the markets during a particular vintage. In the CMBS market, there is a material difference in the outlook for the performance of loans originated in 2005 and earlier relative to loans originated in 2006 through 2008. For loans originated prior to 2006, underwriting assumptions were more conservative regarding required debt service coverage and loan-to-value ratios. For the 2006 through 2008 vintages, real estate values peaked and the underwriting expectations were that values would continue to increase, which makes those loan values more sensitive to market declines. The 2009 through 2011 vintages represent a return to debt service coverage ratios and loan-to-value ratios that more closely resemble loans originated prior to 2006.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

We purchase ABS to diversify the overall credit risks of the fixed maturities portfolio and to provide attractive returns. The principal risks in holding ABS are structural and credit risks. Structural risks include the security's priority in the issuer's capital structure, the adequacy of and ability to realize proceeds from the collateral and the potential for prepayments. Credit risks involve issuer/servicer risk where collateral values can become impaired in the event of servicer credit deterioration. Our ABS portfolio is diversified both by type of asset and by issuer. We actively monitor holdings of ABS to ensure that the risk profile of each security improves or remains consistent. Prepayments in the ABS portfolio are, in general, insensitive to changes in interest rates or are insulated from such changes by call protection features. In the event that we are subject to prepayment risk, we monitor the factors that impact the level of prepayment and prepayment speed for those ABS. In addition, we diversify the risks of ABS by holding a diverse class of securities, which limits our exposure to any one security.

The international exposure held in our U.S. operation's fixed maturities portfolio was 24% of total fixed maturities as of both March 31, 2011 and December 31, 2010. It is comprised of corporate and foreign government fixed maturities. The following table presents the carrying amount of our international exposure for our U.S. operation's fixed maturities portfolio for the periods indicated.

Table of Contents

	March 31, 2011		December 31, 2010
	(in millions)		
European Union	\$ 3,494.2	\$	3,336.6
United Kingdom	2,366.3		2,304.3
Australia	1,271.8		1,279.4
Asia	860.0		892.2
South America	546.1		522.2
Other countries (1)	2,633.4		2,571.6
Total	\$ 11,171.8	\$	10,906.3

(1) Includes exposure from 25 countries as of March 31, 2011, and 24 countries as of December 31, 2010.

All international fixed maturities held by our U.S. operations are either denominated in U.S. dollars or have been swapped into U.S. dollar equivalents. Our international investments are analyzed internally by country and industry credit investment professionals. We control concentrations using issuer and country level exposure benchmarks, which are based on the credit quality of the issuer and the country. Our investment policy limits total international fixed maturities investments and we are within those internal limits. Exposure to Canada is not included in our international exposure. As of March 31, 2011 and December 31, 2010, our investments in Canada totaled \$1,620.3 million and \$1,680.3 million, respectively.

**Fixed Maturities Credit Concentrations.** One aspect of managing credit risk is through industry, issuer and asset class diversification. Our credit concentrations are managed to established limits. The exposure attributed to monoline bond and mortgage insurers from investments that are guaranteed by them is not included in the evaluation of our top ten exposures. We are not relying on said guarantors and are directly evaluating exposure to these investments. The following table presents our top ten exposures as of March 31, 2011.

	Amortized cost (in millions)
Wells Fargo & Co.	\$ 231.2
General Electric Co.	226.2
Berkshire Hathaway Inc.	217.2
JP Morgan Chase & Co.	206.2
Export Import Bank of U.S.	199.9
Bank of America Corp. (1)	184.1
AT&T Inc.	176.1
Verizon Communications Inc.	166.2
Westpac Banking Corp.	164.6
Credit Suisse Group AG (1)	164.2
Total top ten exposures	\$ 1,935.9

(1) Includes actual counterparty exposure.

We had exposure to monoline bond and mortgage insurers with an amortized cost of \$654.6 million and a carrying amount of \$663.5 million as of March 31, 2011. The \$654.6 million includes wrapped guarantees on \$638.7 million of underlying municipal bonds, corporate credit or ABS.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Our direct exposure to these insurers was \$15.9 million. Of the \$638.7 million in wrapped guarantees, 43% was investment grade municipal bonds; 41% was investment grade bank perpetual preferred securities; 9% was ABS backed by sub-prime or Alt-A first lien mortgages, of which 34% was investment grade; and 7% was corporate fixed maturities, of which 94% was investment grade.



Table of Contents

**Fixed Maturities Valuation and Credit Quality.** Valuation techniques for the fixed maturities portfolio vary by security type and the availability of market data. The use of different pricing techniques and their assumptions could produce different financial results. See Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 9, Fair Value Measurements for further details regarding our pricing methodology. Once prices are determined, they are reviewed by pricing analysts for reasonableness based on asset class and observable market data. In addition, investment analysts who are familiar with specific securities review prices for reasonableness through direct interaction with external sources, review of recent trade activity or use of internal models. All fixed maturities placed on the watch list are periodically analyzed by investment analysts or analysts that focus on troubled securities ( Workout Group ). This group then meets with the Chief Investment Officer and the Portfolio Managers to determine reasonableness of prices. The valuation of impaired bonds for which there is no quoted price is typically based on the present value of the future cash flows expected to be received. Although we believe these values reasonably reflect the fair value of those securities, the key assumptions about risk premiums, performance of underlying collateral (if any) and other market factors involve qualitative and unobservable inputs.

The Securities Valuation Office ( SVO ) of the National Association of Insurance Commissioners ( NAIC ) monitors the bond investments of insurers for regulatory capital and reporting purposes and, when required, assigns securities to one of six investment categories. For certain bonds, the NAIC designations closely mirror the NRSROs credit ratings. For most corporate bonds, NAIC designations 1 and 2 include bonds considered investment grade by such rating organizations. Bonds are considered investment grade when rated Baa3 or higher by Moody s, or BBB- or higher by Standard & Poor s. NAIC designations 3 through 6 are referred to as below investment grade. Bonds are considered below investment grade when rated Ba1 or lower by Moody s, or BB+ or lower by Standard & Poor s.

However, for loan-backed and structured securities, as defined by the NAIC, the NAIC rating is not always equivalent to an NRSRO rating as described below. For non-agency RMBS, PIMCO Advisors models and assigns the NAIC ratings. Effective December 31, 2010, the NAIC revised its rating methodology process for CMBS and retained Blackrock Solutions to undertake the modeling and assignment of those NAIC ratings. The NAIC expanded its definition of other loan-backed and structured securities in 2010. Effective January 1, 2011, these securities are subject to an intrinsic price matrix as provided by the NAIC. The NAIC s stated objective for the revised rating methodologies was to improve the accuracy in assessing expected losses and determining an appropriate risk-based capital requirement for these assets. This may result in a final designation being higher or lower than the NRSRO credit rating. In addition, for those other loan-backed and structured securities without a current rating, an NAIC 6 rating is assigned. Our below investment grade assets increased at March 31, 2011, primarily due to the revised rating methodologies.

The following table presents our total fixed maturities by NAIC designation and the equivalent ratings of the NRSROs as of the periods indicated as well as the percentage, based on fair value, that each designation comprises.

NAIC Rating	Rating Agency Equivalent	March 31, 2011			December 31, 2010		
		Amortized cost	Carrying amount	% of total carrying amount	Amortized cost	Carrying amount	% of total carrying amount
(\$ in millions)							
1	AAA/AA/A	\$ 26,196.3	\$ 27,015.8	59%	\$ 26,765.7	\$ 27,433.1	59%
2	BBB	13,834.3	14,485.1	31	14,445.7	15,027.8	33
3	BB	2,897.5	2,814.7	6	2,599.5	2,460.0	5
4	B	939.7	815.0	2	883.6	739.1	2
5	CCC and lower	528.2	450.8	1	567.1	451.5	1
6	In or near default	469.0	305.4	1	329.0	174.9	
	Total fixed maturities	\$ 44,865.0	\$ 45,886.8	100%	\$ 45,590.6	\$ 46,286.4	100%

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Fixed maturities include 20 securities with an amortized cost of \$137.7 million, gross gains of \$1.5 million, gross losses of \$3.4 million and a carrying amount of \$135.8 million as of March 31, 2011, that are still pending a review and assignment of a rating by the SVO. Due to the timing of when fixed maturities are purchased, legal documents are filed and the review by the SVO is completed, there will always be securities in our portfolio that are unrated over a reporting period. In these instances, an equivalent rating is assigned based on our fixed income analyst's assessment.

***Commercial Mortgage-Backed Securities and Home Equity Asset-Backed Securities Portfolios.*** As of March 31, 2011, based on amortized cost, 58% of our CMBS portfolio had ratings of A or higher and 46% was issued in 2005 or before and 15% of our ABS home equity portfolio had ratings of A or higher and 86% was issued in 2005 or before.

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Table of Contents

The following tables present our exposure by credit quality and year of issuance ( vintage ) for our CMBS portfolio as of the periods indicated.

	March 31, 2011											
	AAA		AA		A		BBB		BB+ and Below		Total	
	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount
	(in millions)											
2003 &												
Prior	\$ 280.2	\$ 273.6	\$ 100.4	\$ 102.1	\$ 109.7	\$ 108.6	\$ 151.4	\$ 139.2	\$ 120.7	\$ 79.6	\$ 762.4	\$ 703.1
2004	258.3	266.3	46.7	47.7	57.1	54.2	50.3	35.3	71.6	55.5	484.0	459.0
2005	383.8	410.2	43.3	47.0	25.3	22.1	72.9	66.2	221.9	154.7	747.2	700.2
2006	229.5	229.5	8.6	10.3	74.9	78.8	19.2	20.7	159.6	100.6	491.8	439.9
2007	357.4	353.5	56.8	62.2	186.0	201.2	263.3	273.0	656.5	462.2	1,520.0	1,352.1
2008			15.1	15.9	32.9	36.4	11.8	12.2	31.3	33.2	91.1	97.7
2009	107.5	111.8	16.2	16.0							123.7	127.8
2010	55.7	58.3	12.2	12.3							67.9	70.6
2011	34.2	34.0			3.6	3.7					37.8	37.7
Total	\$ 1,706.6	\$ 1,737.2	\$ 299.3	\$ 313.5	\$ 489.5	\$ 505.0	\$ 568.9	\$ 546.6	\$ 1,261.6	\$ 885.8	\$ 4,325.9	\$ 3,988.1

	December 31, 2010											
	AAA		AA		A		BBB		BB+ and Below		Total	
	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount
	(in millions)											
2003 &												
Prior	\$ 372.4	\$ 368.5	\$ 119.9	\$ 120.8	\$ 140.6	\$ 136.5	\$ 149.1	\$ 138.9	\$ 118.4	\$ 77.3	\$ 900.4	\$ 842.0
2004	262.6	270.5	58.4	58.3	52.1	46.3	50.3	33.6	71.5	51.9	494.9	460.6
2005	411.0	439.3	28.6	30.8	25.3	20.4	92.8	75.3	214.2	120.4	771.9	686.2
2006	216.3	216.7	9.0	11.0	75.0	78.6	19.1	19.7	171.2	81.1	490.6	407.1
2007	376.8	374.2	65.7	70.3	179.8	191.4	278.4	280.2	648.1	317.5	1,548.8	1,233.6
2008			15.0	15.7	32.9	35.8	11.8	9.6	31.2	19.3	90.9	80.4
2009	91.3	95.0									91.3	95.0
2010	37.9	39.0	3.3	3.4							41.2	42.4
Total	\$ 1,768.3	\$ 1,803.2	\$ 299.9	\$ 310.3	\$ 505.7	\$ 509.0	\$ 601.5	\$ 557.3	\$ 1,254.6	\$ 667.5	\$ 4,430.0	\$ 3,847.3

The following tables present our exposure by credit quality and vintage for our ABS home equity portfolio supported by subprime first lien mortgages as of the periods indicated.

	March 31, 2011											
	AAA		AA		A		BBB		BB+ and Below		Total	
	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount	Amortized cost	Carrying amount
	(in millions)											
2003 &												
Prior	\$ 19.0	\$ 19.0	\$ 7.5	\$ 7.4	\$ 6.4	\$ 6.0	\$ 65.7	\$ 60.8	\$ 111.0	\$ 88.5	\$ 209.6	\$ 181.7
2004	1.5	1.4	14.7	14.2	8.4	8.0	1.7	1.4	46.8	40.8	73.1	65.8
2005			3.1	3.2			2.0	1.5	67.3	50.9	72.4	55.6
2006									15.7	13.2	15.7	13.2
2007									40.9	32.7	40.9	32.7
Total	\$ 20.5	\$ 20.4	\$ 25.3	\$ 24.8	\$ 14.8	\$ 14.0	\$ 69.4	\$ 63.7	\$ 281.7	\$ 226.1	\$ 411.7	\$ 349.0

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

	December 31, 2010												
	AAA		AA		A		BBB		BB and Below		Total		
	Amortized	Carrying	Amortized	Carrying	Amortized	Carrying	Amortized	Carrying	Amortized	Carrying	Amortized	Carrying	
	cost	amount	cost	amount	cost	amount	cost	amount	cost	amount	cost	amount	
	(in millions)												
2003 &													
Prior	\$ 34.2	\$ 33.7	\$ 55.1	\$ 50.5	\$ 8.2	\$ 7.4	\$ 52.8	\$ 45.0	\$ 64.8	\$ 48.0	\$ 215.1	\$ 184.6	
2004	27.7	26.0	4.3	4.2	25.5	21.8	11.9	11.0	5.2	4.5	74.6	67.5	
2005			3.1	3.2			2.0	1.4	74.1	54.6	79.2	59.2	
2006									15.7	11.0	15.7	11.0	
2007									47.5	37.9	47.5	37.9	
Total	\$ 61.9	\$ 59.7	\$ 62.5	\$ 57.9	\$ 33.7	\$ 29.2	\$ 66.7	\$ 57.4	\$ 207.3	\$ 156.0	\$ 432.1	\$ 360.2	

Table of Contents

**Fixed Maturities Watch List.** We monitor any decline in the credit quality of fixed maturities through the designation of problem securities, potential problem securities and restructured securities. We define problem securities in our fixed maturity portfolio as securities: (i) as to which principal and/or interest payments are in default or where default is perceived to be imminent in the near term, or (ii) issued by a company that went into bankruptcy subsequent to the acquisition of such securities. We define potential problem securities in our fixed maturity portfolio as securities included on an internal watch list for which management has concerns as to the ability of the issuer to comply with the present debt payment terms and which may result in the security becoming a problem or being restructured. The decision whether to classify a performing fixed maturity security as a potential problem involves significant subjective judgments by our management as to the likely future industry conditions and developments with respect to the issuer. We define restructured securities in our fixed maturity portfolio as securities where a concession has been granted to the borrower related to the borrower's financial difficulties that would not have otherwise been considered. We determine that restructures should occur in those instances where greater economic value will be realized under the new terms than through liquidation or other disposition and may involve a change in contractual cash flows. If the present value of the restructured cash flows is less than the current cost of the asset being restructured, a realized capital loss is recorded in net income and a new cost basis is established.

The following table presents the total carrying amount of our fixed maturities portfolio, as well as its problem, potential problem and restructured fixed maturities for the periods indicated.

	March 31, 2011	December 31, 2010
	(\$ in millions)	
Total fixed maturities (public and private)	\$ 45,886.8	\$ 46,286.4
Problem fixed maturities (1)	\$ 415.9	\$ 378.7
Potential problem fixed maturities	272.6	237.6
Restructured problem fixed maturities	19.3	17.4
Total problem, potential problem and restructured fixed maturities	\$ 707.8	\$ 633.7
Total problem, potential problem and restructured fixed maturities as a percent of total fixed maturities	1.54%	1.37%

(1) The problem fixed maturities carrying amount is net of other-than-temporary impairment losses.

**Fixed Maturities Impairments.** We have a process in place to identify securities that could potentially have a credit impairment that is other than temporary. This process involves monitoring market events that could impact issuers' credit ratings, business climate, management changes, litigation and government actions and other similar factors. This process also involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues.

Each reporting period, a group of individuals including the Chief Investment Officer, our Portfolio Managers, members of our Workout Group and representatives from Investment Accounting review all securities to determine whether an other-than-temporary decline in value exists and whether losses should be recognized. The analysis focuses on each issuer's ability to service its debts in a timely fashion. Formal documentation of the analysis and our decision is prepared and approved by management.

We consider relevant facts and circumstances in evaluating whether a credit or interest-rate related impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events; (4) for structured securities, the adequacy of the expected cash flows and (5) our intent to sell the security or whether it is more

likely than not we will be required to sell the security before recovery of its amortized cost which, in some cases, may extend to maturity. To the extent we determine that a security is deemed to be other-than-temporarily impaired, an impairment loss is recognized. For additional details, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 3, Investments.

Table of Contents

When it is not our intent to sell a security with unrealized losses, it is not more likely than not that we would be required to sell the security before recovery of the amortized cost, which may be maturity, and we expect to recover the amortized cost basis, we would not consider the security to be other-than-temporarily impaired. However, we do sell bonds under certain circumstances, such as when we have evidence of a significant deterioration in the issuer's creditworthiness, when a change in regulatory requirements modifies what constitutes a permissible investment or the maximum level of investments held or when there is an increase in capital requirements or a change in risk weights of debt securities. Sales generate both gains and losses.

There are a number of significant risks and uncertainties inherent in the process of monitoring credit impairments and determining if an impairment is other than temporary. These risks and uncertainties include: (1) the risk that our assessment of an issuer's ability to meet all of its contractual obligations will change based on changes in the credit characteristics of that issuer, (2) the risk that the economic outlook will be worse than expected or have more of an impact on the issuer than anticipated, (3) the risk that our investment professionals are making decisions based on fraudulent or misstated information in the financial statements provided by issuers and (4) the risk that new information obtained by us or changes in other facts and circumstances lead us to change our intent to not sell the security prior to recovery of its amortized cost. Any of these situations could result in a charge to net income in a future period.

The net realized loss relating to other-than-temporary credit impairments and credit related sales of fixed maturities was \$54.9 million and \$83.2 million for the three months ended March 31, 2011 and 2010, respectively.

Table of Contents*Fixed Maturities Available-for-Sale*

The following tables present our fixed maturities available-for-sale by industry category and the associated gross unrealized gains and losses, including other-than-temporary impairment losses reported in AOCI, as of the periods indicated.

		March 31, 2011			
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Carrying amount
		(in millions)			
Finance	Banking	\$ 4,650.3	\$ 117.1	\$ 224.6	\$ 4,542.8
Finance	Brokerage	406.6	19.5	2.0	424.1
Finance	Finance Companies	208.7	11.5	1.4	218.8
Finance	Financial Other	488.4	37.0	1.4	524.0
Finance	Insurance	2,702.5	119.2	48.1	2,773.6
Finance	REITS	1,163.1	39.4	18.6	1,183.9
Industrial	Basic Industry	1,692.1	100.5	3.2	1,789.4
Industrial	Capital Goods	2,111.7	121.3	7.0	2,226.0
Industrial	Communications	2,187.2	160.1	9.0	2,338.3
Industrial	Consumer Cyclical	1,597.8	101.5	8.4	1,690.9
Industrial	Consumer Non-Cyclical	3,176.8	220.5	17.6	3,379.7
Industrial	Energy	2,046.0	165.3	5.4	2,205.9
Industrial	Other	710.8	42.2	4.9	748.1
Industrial	Technology	774.5	41.4	4.8	811.1
Industrial	Transportation	703.3	36.3	9.1	730.5
Utility	Electric	2,576.3	150.6	18.1	2,708.8
Utility	Natural Gas	1,044.8	70.6	3.0	1,112.4
Utility	Other	146.4	13.6		160.0
	FDIC guaranteed	96.1	1.7		97.8
	Government guaranteed	1,138.5	98.5	5.8	1,231.2
	Total corporate securities	29,621.9	1,667.8	392.4	30,897.3
	Residential mortgage-backed pass-through securities	3,037.9	109.4	9.7	3,137.6
	Commercial mortgage-backed securities	4,278.0	140.4	478.2	3,940.2
	Residential collateralized mortgage obligations (1)	1,417.6	26.2	36.9	1,406.9
	Asset-backed securities Home equity (2)	411.7	0.8	63.5	349.0
	Asset-backed securities All other	1,414.5	27.9	0.8	1,441.6
	Collateralized debt obligations Credit	91.0		31.7	59.3
	Collateralized debt obligations CMBS	99.8	1.2	22.2	78.8
	Collateralized debt obligations Loans	154.0	1.0	8.0	147.0
	Collateralized debt obligations ABS (3)	15.0	0.5	0.3	15.2
	Total mortgage-backed and other asset-backed securities	10,919.5	307.4	651.3	10,575.6
	U.S. government and agencies	532.6	18.7	0.3	551.0
	States and political subdivisions	2,625.3	63.2	23.4	2,665.1
	Non-U.S. governments	376.8	32.4	0.3	408.9
	Total fixed maturities, available-for-sale	\$ 44,076.1	\$ 2,089.5	\$ 1,067.7	\$ 45,097.9

(1) Includes exposure to Alt-a mortgage loans with an amortized cost of \$52.9 million, gross unrealized gains of \$1.2 million, gross unrealized losses of \$1.8 million and a carrying amount of \$52.3 million. The Alt-a portfolio has a weighted average rating of BBB+ and 64% are 2005 and prior vintages.



- (2) This exposure is all related to sub-prime mortgage loans.
- (3) Includes exposure to sub-prime mortgage loans with an amortized cost of \$0.0 million, gross unrealized gains of \$0.5 million, and a carrying amount of \$0.5 million.

Table of Contents

		December 31, 2010			
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Carrying amount
		(in millions)			
Finance	Banking	\$ 4,598.3	\$ 110.2	\$ 279.2	\$ 4,429.3
Finance	Brokerage	418.4	16.8	2.6	432.6
Finance	Finance Companies	267.3	11.2	4.5	274.0
Finance	Financial Other	446.6	36.1	2.3	480.4
Finance	Insurance	2,723.4	109.7	73.3	2,759.8
Finance	REITS	1,210.6	33.7	27.8	1,216.5
Industrial	Basic Industry	1,750.4	107.7	5.1	1,853.0
Industrial	Capital Goods	2,262.3	137.8	7.3	2,392.8
Industrial	Communications	2,184.4	163.4	11.9	2,335.9
Industrial	Consumer Cyclical	1,616.3	109.9	10.9	1,715.3
Industrial	Consumer Non-Cyclical	3,147.4	240.0	20.4	3,367.0
Industrial	Energy	2,069.5	166.7	5.0	2,231.2
Industrial	Other	657.6	36.6	5.5	688.7
Industrial	Technology	793.8	42.0	5.8	830.0
Industrial	Transportation	679.7	39.9	11.3	708.3
Utility	Electric	2,608.4	169.3	19.5	2,758.2
Utility	Natural Gas	1,073.2	75.1	3.4	1,144.9
Utility	Other	156.6	15.5		172.1
	FDIC guaranteed	95.6	2.0		97.6
	Government guaranteed	1,158.0	101.6	5.9	1,253.7
	Total corporate securities	29,917.8	1,725.2	501.7	31,141.3
	Residential mortgage-backed pass-through securities	3,047.8	122.1	5.9	3,164.0
	Commercial mortgage-backed securities	4,424.9	118.0	700.7	3,842.2
	Residential collateralized mortgage obligations (1)	1,427.7	28.6	50.8	1,405.5
	Asset-backed securities Home equity (2)	432.1	0.6	72.5	360.2
	Asset-backed securities All other	1,325.1	24.5	1.2	1,348.4
	Collateralized debt obligations Credit	90.8		36.4	54.4
	Collateralized debt obligations CMBS	113.8	0.4	36.8	77.4
	Collateralized debt obligations Loans	141.2	0.8	6.6	135.4
	Collateralized debt obligations ABS (3)	34.7	0.5	9.4	25.8
	Total mortgage-backed and other asset-backed securities	11,038.1	295.5	920.3	10,413.3
	U.S. government and agencies	748.5	21.0	0.2	769.3
	States and political subdivisions	2,615.0	64.7	23.3	2,656.4
	Non-U.S. governments	389.3	34.9		424.2
	Total fixed maturities, available-for-sale	\$ 44,708.7	\$ 2,141.3	\$ 1,445.5	\$ 45,404.5

- (1) Includes exposure to Alt-a mortgage loans with an amortized cost of \$54.9 million, gross unrealized gains of \$0.2 million, gross unrealized losses of \$5.5 million and a carrying amount of \$49.6 million. The Alt-a portfolio has a weighted average rating of A- and 63% are 2005 and prior vintages.
- (2) This exposure is all related to sub-prime mortgage loans.
- (3) Includes exposure to sub-prime mortgage loans with an amortized cost of \$19.7 million, gross unrealized gains of \$0.5 million, gross unrealized losses of \$8.9 million and a carrying amount of \$11.3 million.

Table of Contents

Of the \$1,067.7 million in gross unrealized losses as of March 31, 2011, there were \$1.7 million in losses attributed to securities scheduled to mature in one year or less, \$36.8 million attributed to securities scheduled to mature between one to five years, \$61.7 million attributed to securities scheduled to mature between five to ten years, \$316.2 million attributed to securities scheduled to mature after ten years and \$651.3 million related to mortgage-backed and other ABS that are not classified by maturity year. As of March 31, 2011, we were in a \$1,021.8 million net unrealized gain position as compared to a \$695.8 million net unrealized gain position as of December 31, 2010. Of the \$326.0 million increase in net unrealized gains for the three months ended March 31, 2011, an approximate \$0.4 billion net unrealized loss can be attributed to an approximate 17 basis points increase in interest rates and is more than offset by net unrealized gains related to other market factors.

**Fixed Maturities Available-for-Sale Unrealized Losses.** We believe that our long-term fixed maturities portfolio is well diversified among industry types and between publicly traded and privately placed securities. Each year, we direct the majority of our net cash inflows into investment grade fixed maturities. The net cash inflows into investment grade fixed maturities are less than prior years due to us investing in more liquid investments. Our current policy is to limit the percentage of cash flow invested in below investment grade assets to 10% of cash flow. During first quarter 2011, we did not actively increase our investment in available-for-sale below investment grade assets. While Principal Life's general account investment returns have improved due to the below investment grade asset class, we manage its growth strategically by limiting it to no more than 10% of the total fixed maturities portfolios.

We invest in privately placed fixed maturities to enhance the overall value of the portfolio, increase diversification and obtain higher yields than are possible with comparable quality public market securities. Generally, private placements provide broader access to management information, strengthened negotiated protective covenants, call protection features and, where applicable, a higher level of collateral. They are, however, generally not freely tradable because of restrictions imposed by federal and state securities laws and illiquid trading markets.

The following table presents our fixed maturities available-for-sale by investment grade and below investment grade and the associated gross unrealized gains and losses, including other-than-temporary impairment losses reported in OCI, as of the periods indicated.

	March 31, 2011			Carrying amount (in millions)	December 31, 2010			Carrying amount
	Amortized cost	Gross unrealized gains	Gross unrealized losses		Amortized cost	Gross unrealized gains	Gross unrealized losses	
Investment grade:								
Public	\$ 27,522.5	\$ 1,347.1	\$ 252.7	\$ 28,616.9	\$ 28,496.5	\$ 1,429.0	\$ 394.5	\$ 29,531.0
Private	11,935.5	621.0	245.1	12,311.4	12,071.9	621.4	406.4	12,286.9
Below investment grade:								
Public	2,401.0	58.0	261.2	2,197.8	2,087.8	39.1	305.3	1,821.6
Private	2,217.1	63.4	308.7	1,971.8	2,052.5	51.8	339.3	1,765.0
Total fixed maturities, available-for-sale	\$ 44,076.1	\$ 2,089.5	\$ 1,067.7	\$ 45,097.9	\$ 44,708.7	\$ 2,141.3	\$ 1,445.5	\$ 45,404.5

Table of Contents

The following tables present the carrying amount and the gross unrealized losses, including other-than-temporary impairment losses reported in OCI, on investment grade fixed maturities available-for-sale by aging category as of the periods indicated.

	Public		March 31, 2011 Private		Total	
	Carrying Amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 1,095.8	\$ 8.7	\$ 590.2	\$ 4.9	\$ 1,686.0	\$ 13.6
Greater than three to six months	1,723.2	43.0	503.1	14.7	2,226.3	57.7
Greater than six to nine months	112.0	5.4	35.3	0.2	147.3	5.6
Greater than nine to twelve months	112.8	3.9	34.8	1.7	147.6	5.6
Greater than twelve to twenty-four months	137.4	9.4	60.0	6.8	197.4	16.2
Greater than twenty-four to thirty-six months	171.2	19.6	267.5	37.6	438.7	57.2
Greater than thirty-six months	1,281.7	162.7	1,335.0	179.2	2,616.7	341.9
Total fixed maturities, available-for-sale	\$ 4,634.1	\$ 252.7	\$ 2,825.9	\$ 245.1	\$ 7,460.0	\$ 497.8

	Public		December 31, 2010 Private		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 2,534.3	\$ 45.9	\$ 999.8	\$ 21.9	\$ 3,534.1	\$ 67.8
Greater than three to six months	157.9	6.8	59.3	1.4	217.2	8.2
Greater than six to nine months	186.3	5.5	65.1	2.1	251.4	7.6
Greater than nine to twelve months	103.3	3.4	5.1	0.1	108.4	3.5
Greater than twelve to twenty-four months	92.0	19.6	81.7	10.7	173.7	30.3
Greater than twenty-four to thirty-six months	541.6	86.1	437.0	89.4	978.6	175.5
Greater than thirty-six months	1,440.9	227.2	1,485.5	280.8	2,926.4	508.0
Total fixed maturities, available-for-sale	\$ 5,056.3	\$ 394.5	\$ 3,133.5	\$ 406.4	\$ 8,189.8	\$ 800.9

The following tables present the carrying amount and the gross unrealized losses, including other-than-temporary impairment losses reported in OCI, on below investment grade fixed maturities available-for-sale by aging category as of the periods indicated.

	Public		March 31, 2011 Private		Total	
	Carrying Amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 89.7	\$ 1.3	\$ 102.7	\$ 2.6	\$ 192.4	\$ 3.9
Greater than three to six months	29.2	0.8	19.6	3.7	48.8	4.5
Greater than six to nine months			13.6	0.6	13.6	0.6
Greater than nine to twelve months	7.3	1.0			7.3	1.0
Greater than twelve to twenty-four months	31.9	1.1	11.1	0.8	43.0	1.9
Greater than twenty-four to thirty-six months	78.2	7.1	57.9	15.7	136.1	22.8
Greater than thirty-six months	1,046.5	249.9	738.1	285.3	1,784.6	535.2
Total fixed maturities, available-for-sale	\$ 1,282.8	\$ 261.2	\$ 943.0	\$ 308.7	\$ 2,225.8	\$ 569.9



Table of Contents

	Public		December 31, 2010 Private		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 70.1	\$ 1.0	\$ 70.9	\$ 4.6	\$ 141.0	\$ 5.6
Greater than three to six months	15.1	0.3	8.9	0.1	24.0	0.4
Greater than six to nine months	7.2	1.1			7.2	1.1
Greater than nine to twelve months	32.0	1.2	11.5	0.6	43.5	1.8
Greater than twelve to twenty-four months	5.9	1.9	0.2	0.1	6.1	2.0
Greater than twenty-four to thirty-six months	233.9	43.9	175.1	89.0	409.0	132.9
Greater than thirty-six months	807.4	255.9	495.8	244.9	1,303.2	500.8
Total fixed maturities, available-for-sale	\$ 1,171.6	\$ 305.3	\$ 762.4	\$ 339.3	\$ 1,934.0	\$ 644.6

The following tables present the carrying amount and the gross unrealized losses, including other-than-temporary impairment losses reported in OCI, on fixed maturities available-for-sale where the estimated fair value had declined and remained below amortized cost by 20% or more as of the periods indicated.

	Problem, potential problem, and restructured		March 31, 2011 All other fixed maturity securities		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$	\$	\$ 34.8	\$ 10.0	\$ 34.8	\$ 10.0
Greater than three to six months	15.2	4.6	5.2	1.5	20.4	6.1
Greater than six to nine months	0.8	1.1	5.4	2.0	6.2	3.1
Greater than nine to twelve months	0.1		14.1	5.1	14.2	5.1
Greater than twelve months	262.2	258.6	688.5	386.9	950.7	645.5
Total fixed maturities, available-for-sale	\$ 278.3	\$ 264.3	\$ 748.0	\$ 405.5	\$ 1,026.3	\$ 669.8

	Problem, potential problem, and restructured		December 31, 2010 All other fixed maturity securities		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 39.6	\$ 11.1	\$ 57.7	\$ 16.5	\$ 97.3	\$ 27.6
Greater than three to six months	0.9	1.1	15.1	4.9	16.0	6.0
Greater than six to nine months	0.1		113.8	33.3	113.9	33.3
Greater than nine to twelve months						
Greater than twelve months	251.4	403.6	792.8	529.4	1,044.2	933.0
Total fixed maturities, available-for-sale	\$ 292.0	\$ 415.8	\$ 979.4	\$ 584.1	\$ 1,271.4	\$ 999.9

**Mortgage Loans**

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

Mortgage loans consist of commercial mortgage loans on real estate and residential mortgage loans. The carrying amount of our commercial mortgage loan portfolio was \$9,421.3 million and \$9,599.6 million as of March 31, 2011 and December 31, 2010, respectively. The carrying amount of our residential mortgage loan portfolio was \$841.6 million and \$877.5 million as of March 31, 2011 and December 31, 2010, respectively.

**Commercial Mortgage Loans.** We generally report commercial mortgage loans on real estate at cost adjusted for amortization of premiums and accrual of discounts, computed using the interest method and net of valuation allowances.

Commercial mortgage loans play an important role in our investment strategy by:

- providing strong risk-adjusted relative value in comparison to other investment alternatives;

Table of Contents

- enhancing total returns and
- providing strategic portfolio diversification.

As a result, we have focused on constructing a solid, high quality portfolio of mortgages. Our portfolio is generally comprised of mortgages originated with conservative loan-to-value ratios, high debt service coverages and general purpose property types with a strong credit tenancy.

Our commercial mortgage loan portfolio consists primarily of non-recourse, fixed rate mortgages on fully or near fully leased properties. The mortgage portfolio is comprised primarily of credit oriented retail properties, office properties and general-purpose industrial properties.

Our commercial mortgage loan portfolio is diversified by geography and specific collateral property type. Commercial mortgage lending in the state of California accounted for 22% of our commercial mortgage loan portfolio as of both March 31, 2011 and December 31, 2010. We are, therefore, exposed to potential losses resulting from the risk of catastrophes, such as earthquakes, that may affect the region. Like other lenders, we generally do not require earthquake insurance for properties on which we make commercial mortgage loans. With respect to California properties, however, we obtain an engineering report specific to each property. The report assesses the building's design specifications, whether it has been upgraded to meet seismic building codes and the maximum loss that is likely to result from a variety of different seismic events. We also obtain a report that assesses, by building and geographic fault lines, the amount of loss our commercial mortgage loan portfolio might suffer under a variety of seismic events.

The typical borrower in our commercial loan portfolio is a single purpose entity or single asset entity. As of March 31, 2011 and December 31, 2010, 31% and 30%, respectively, of the commercial mortgage loan portfolio was comprised of mortgage loans with principal balances of less than \$10.0 million. The total number of commercial mortgage loans outstanding was 1,017 and 1,033 as of March 31, 2011 and December 31, 2010, respectively. The average loan size of our commercial mortgage portfolio was \$9.3 million and \$9.4 million as of March 31, 2011 and December 31, 2010, respectively.

**Commercial Mortgage Loan Credit Monitoring.** For further details on monitoring and management of our commercial mortgage loan portfolio, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 3, Investments – Mortgage Loan Credit Monitoring.

We categorize loans that are 60 days or more delinquent, loans in process of foreclosure and loans with borrowers or credit tenants in bankruptcy that are delinquent as problem loans. Valuation allowances or charge-offs have been recognized on most problem loans. We categorize loans that are delinquent less than 60 days where the default is expected to be cured and loans with borrowers or credit tenants in bankruptcy that are current as potential problem loans. The decision whether to classify a loan delinquent less than 60 days as a potential problem involves significant subjective judgments by management as to the likely future economic conditions and developments with respect to the borrower. We categorize loans for which the original note rate has been reduced below market and loans for which the principal has been reduced as restructured loans. We also consider loans that are refinanced more than one year beyond the original maturity or call date at below market rates as restructured.



## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

There was a significant increase in the level of problem, potential problem, and restructured commercial mortgages during 2009 due to the impact of the U.S. recession on commercial real estate, peaking at year-end 2009. The job losses and record foreclosures in housing negatively impacted property vacancy rates and rental rates. There was a steady decrease in the level of problem, potential problem and restructured commercial mortgages during 2010 due to write downs, payoffs, loan sales and the internal refinance of several loans at market terms. The increase in the level of problem, potential problem and restructured commercial mortgages during the first quarter of 2011 was primarily due to an increase in vacancy, related to both credit issues and expected rollover. The South Atlantic, East North Central and Pacific regions account for the majority of the problem, potential problem and restructured commercial mortgages as of March 31, 2011. The South Atlantic region accounted for the majority of the problem, potential problem, and restructured commercial mortgages as of December 31, 2010. Office and industrial properties accounted for over half of the problem, potential problem and restructured commercial mortgages as of March 31, 2011. Apartments and industrial properties accounted for over half of the problem, potential problem and restructured commercial mortgages as of December 31, 2010.

Table of Contents

The following table presents the carrying amounts of problem, potential problem and restructured commercial mortgages relative to the carrying amount of all commercial mortgages for the periods indicated.

	March 31, 2011	December 31, 2010
	(\$ in millions)	
Total commercial mortgages	\$ 9,421.3	\$ 9,599.6
Problem commercial mortgages (1)	\$ 49.6	\$ 35.7
Potential problem commercial mortgages	364.0	317.7
Restructured problem commercial mortgages	7.5	7.5
Total problem, potential problem and restructured commercial mortgages	\$ 421.1	\$ 360.9
Total problem, potential problem and restructured commercial mortgages as a percent of total commercial mortgages	4.47%	3.76%

(1) Includes \$13.5 million of commercial mortgage loans in foreclosure as of December 31, 2010.

**Commercial Mortgage Loan Valuation Allowance.** The valuation allowance for commercial mortgage loans includes loan specific reserves for loans that are deemed to be impaired as well as reserves for pools of loans with similar characteristics where a property risk or market specific risk has not been identified but for which we anticipate a loss may occur. For further details on the commercial mortgage valuation allowance, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 3, Investments Mortgage Loan Valuation Allowance.

The valuation allowance increased \$4.5 million for the quarter ended March 31, 2011, and decreased \$51.9 million for the year ended December 31, 2010. The increase in the level of valuation allowance during the first quarter 2011 was related to the same market factors as those causing the increase in the level of problem, potential problem and restructured commercial mortgages during the three months ended March 31, 2011. The decrease in the level of valuation allowance during 2010 was primarily related to loan write downs, payoffs and loan sales and the related release of valuation allowance, which is partially offset by current period provisions. The South Atlantic region accounts for the highest level of reserves at both March 31, 2011 and December 31, 2010.

The following table represents our commercial mortgage valuation allowance for the periods indicated.

	March 31, 2011	December 31, 2010
	(\$ in millions)	
Balance, beginning of period	\$ 80.6	\$ 132.5
Provision	6.9	54.1
Charge-offs	(2.4)	(106.0)
Balance, end of period	\$ 85.1	\$ 80.6
Valuation allowance as % of carrying value before reserves	0.90%	0.83%

**Residential Mortgage Loans.** The residential mortgage loan portfolio before reserves is composed of home equity mortgages of \$688.9 million and \$719.3 million and first lien mortgages of \$190.6 million and \$195.9 million as of March 31, 2011 and December 31, 2010, respectively, primarily held by our Bank and Trust Services business. The home equity loans are generally second lien mortgages made up of closed-end

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

loans and lines of credit. Non-performing residential mortgage loans, which are defined as loans 90 days or greater delinquent plus non-accrual loans, totaled \$24.7 million and \$24.0 million as of March 31, 2011 and December 31, 2010, respectively. We establish the residential mortgage loan valuation allowance at levels considered adequate to absorb probable losses within the portfolio based on management's evaluation of the size and current risk characteristics of the portfolio. Such evaluation considers numerous factors, including, but not limited to net charge-off trends, loss forecasts, collateral values, geographic location, borrower credit scores, delinquency rates, industry condition and economic trends. The changes in the valuation allowance are reported in net realized capital gains (losses) on our consolidated statements of operations.

Table of Contents

Our residential mortgage loan portfolio, and in particular our home equity loan portfolio, experienced an increase in loss severity from sustained elevated levels of unemployment along with continued depressed collateral values in 2010. The deterioration resulted in an increase in delinquencies. The following table represents our residential mortgage valuation allowance for the periods indicated.

	March 31, 2011	December 31, 2010	
	(\$ in millions)		
Balance, beginning of period	\$ 37.7	\$	28.7
Provision	7.3		97.6
Charge-offs	(8.0)		(89.7)
Recoveries	0.9		1.1
Balance, end of period	\$ 37.9	\$	37.7
Valuation allowance as % of carrying value before reserves	4.3%		4.1%

**Real Estate**

Real estate consists primarily of commercial equity real estate. As of March 31, 2011 and December 31, 2010, the carrying amount of our equity real estate investment was \$998.9 million, or 2%, and \$1,052.3 million, or 2%, of U.S. invested assets, respectively. Our commercial equity real estate is held in the form of wholly owned real estate, real estate acquired upon foreclosure of commercial mortgage loans and majority owned interests in real estate joint ventures.

Equity real estate is categorized as either real estate held for investment or real estate held for sale. Real estate held for investment totaled \$940.4 million and \$1,010.7 million as of March 31, 2011 and December 31, 2010, respectively. The carrying value of real estate held for investment is generally adjusted for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Such impairment adjustments are recorded as net realized losses and, accordingly, are reflected in our consolidated results of operations. For the three months ended March 31, 2011 and year ended December 31, 2010, there were no such impairment adjustments.

The carrying amount of real estate held for sale was \$58.5 million and \$41.6 million as of March 31, 2011 and December 31, 2010, respectively. There were no valuation allowances as of March 31, 2011 or December 31, 2010. Once we identify a real estate property to be sold and commence a plan for marketing the property, we classify the property as held for sale. We establish a valuation allowance subject to periodic revisions, if necessary, to adjust the carrying value of the property to reflect the lower of its current carrying value or the fair value, less associated selling costs.

We use research, both internal and external, to recommend appropriate product and geographic allocations and changes to the equity real estate portfolio. We monitor product, geographic and industry diversification separately and together to determine the most appropriate mix.

Equity real estate is distributed across geographic regions of the country with larger concentrations in the South Atlantic and West South Central regions of the United States as of March 31, 2011. By property type, there is a concentration in office, industrial and retail that represented approximately 75% of the equity real estate portfolio as of March 31, 2011.

*Other Investments*

Our other investments totaled \$1,465.9 million as of March 31, 2011, compared to \$1,486.3 million as of December 31, 2010. Derivative assets accounted for \$1,017.9 million and \$1,058.5 million in other investments as of March 31, 2011 and December 31, 2010, respectively. The remaining invested assets include equity method investments, which include real estate properties owned jointly with venture partners and operated by the partners.

Table of Contents**International Investment Operations**

Of our invested assets, \$5.4 billion were held by our Principal International segment as of March 31, 2011. The assets are managed by either our Principal Global Investors segment or by the local Principal International affiliate. Due to the regulatory constraints in each country, each company maintains its own investment policies. As shown in the following table, the major categories of international invested assets as of March 31, 2011 and December 31, 2010, were fixed maturities, other investments and residential mortgage loans. The following table excludes invested assets of the separate accounts.

	March 31, 2011		December 31, 2010	
	Carrying amount	% of total	Carrying amount	% of total
	(\$ in millions)			
Fixed maturities - Public	\$ 3,425.0	64%	\$ 3,470.2	65%
Equity securities	64.9	1	62.7	1
Mortgage loans:				
Commercial	9.1		9.4	
Residential	628.0	12	638.6	12
Real estate held for sale	10.2		10.3	
Real estate held for investment	0.9		0.9	
Policy loans	24.1		24.2	
Other investments	1,210.5	23	1,155.3	22
Total invested assets	5,372.7	100%	5,371.6	100%
Cash and cash equivalents	75.8		60.2	
Total invested assets and cash	\$ 5,448.5		\$ 5,431.8	

Investments in equity method subsidiaries and direct financing leases accounted for \$693.4 million and \$473.5 million, respectively, of other investments as of March 31, 2011. Investments in equity method subsidiaries and direct financing leases accounted for \$667.0 million and \$443.1 million, respectively, of other investments as of December 31, 2010. The remaining other investments as of both March 31, 2011 and December 31, 2010, are primarily related to derivative assets and other short-term investments.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk****Market Risk Exposures and Risk Management**

Market risk is the risk that we will incur losses due to adverse fluctuations in market rates and prices. Our primary market risk exposure is to changes in interest rates, although we also have exposures to changes in equity prices and foreign currency exchange rates.

We enter into market-sensitive instruments primarily for purposes other than trading. The active management of market risk is an integral part of our operations. We manage our overall market risk exposure within established risk tolerance ranges by using the following approaches:

Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

- rebalance our existing asset or liability portfolios;
- control the risk structure of newly acquired assets and liabilities or
- use derivative instruments to modify the market risk characteristics of existing assets or liabilities or assets expected to be purchased.

Table of Contents

**Interest Rate Risk**

Interest rate risk is the risk that we will incur economic losses due to adverse changes in interest rates. One source of interest rate risk is the inherent difficulty in obtaining assets that mature or have their rate reset at the exact same time as the liabilities they support. Assets may have to be reinvested or sold in the future to meet the liability cash flows in unknown interest rate environments. Secondly, there may be timing differences between when new liabilities are priced and when assets are purchased or procured that can cause fluctuations in profitability if interest rates move materially in the interim. A third source of interest rate risk is the prepayment options embedded within asset and liability contracts that can alter the cash flow profiles from what was originally expected.

One of the measures we use to quantify our exposure to interest rate risk is duration. To calculate duration, we project asset and liability cash flows. These cash flows are discounted to a net present value basis using a spot yield curve, which is a blend of the spot yield curves for each of the asset types in the portfolio. Duration is calculated by re-calculating these cash flows, re-determining the net present value based upon an alternative level of interest rates, and determining the percentage change in fair value.

We manage interest rate risks in a number of ways. Differences in durations between assets and liabilities are measured and kept within acceptable tolerances. Derivatives are also commonly used to mitigate interest rate risk due to cash flow mismatches and timing differences. Prepayment risk is controlled by limiting our exposure to investments that are prepayable without penalty prior to maturity at the option of the issuer. We also require additional yield on these investments to compensate for the risk the issuer will exercise such option. Prepayment risk is also controlled by limiting the sales of liabilities with features such as puts or other options that can be exercised against the company at inopportune times. For example, as of March 31, 2011, approximately \$11.1 billion, or 98%, of our institutional GICs and funding agreements cannot be redeemed by contractholders prior to maturity.

We are also exposed to interest rate risk based upon the discount rate assumption used for purposes of valuing our pension and other post retirement benefit obligations.

**Duration-Managed.** Our exposure to interest rate risk stems largely from our substantial holdings of guaranteed fixed rate liabilities in our Retirement and Investor Services segment. We actively manage the duration of assets and liabilities in these products by minimizing the difference between the two.

As of March 31, 2011, the difference between the asset and liability durations on our primary duration-managed portfolio was -0.43, as compared to -0.28 as of December 31, 2010. This duration gap indicates that, as of March 31, 2011, the sensitivity of the fair value of our assets to interest rate movements is less than that of the fair value of our liabilities. Our goal is to minimize the duration gap. Currently, our guidelines indicate that total duration gaps between the asset and liability portfolios should be within +/-0.25. As of March 31, 2011, the mismatch exceeds our duration gap guideline due to temporary asset and liability spread mismatches. However, our cash flow studies reflect our general practice to hold assets and liabilities to maturity and indicate that the interest rate risk is sufficiently managed. The value of the assets in this portfolio was \$26,155.7 million and \$26,601.9 million as of March 31, 2011 and December 31, 2010, respectively.

**Duration-Monitored.** For products such as whole life insurance and term life insurance that are less sensitive to interest rate risk, and for other products such as individual fixed deferred annuities, we manage interest rate risk based on a modeling process that considers the target average



## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

life, maturities, crediting rates and assumptions of policyholder behavior. As of March 31, 2011, the weighted-average difference between the asset and liability durations on these portfolios was -2.57, as compared to -1.54 as of December 31, 2010. This duration gap indicates that, as of March 31, 2011, the sensitivity of the fair value of our assets to interest rate movements is less than that of the fair value of our liabilities. We attempt to monitor this duration gap consistent with our overall risk/reward tolerances. The value of the assets in these portfolios was \$24,733.2 million and \$24,720.0 million as of March 31, 2011 and December 31, 2010, respectively.

**Non Duration-Managed.** We also have a block of participating general account pension business that passes most of the actual investment performance of the assets to the customer. The investment strategy of this block is to maximize investment return to the customer on a best efforts basis, and there is little or no attempt to manage the duration of this portfolio since there is little or no interest rate risk. The value of the assets in these portfolios was \$5,054.0 million and \$5,167.8 million as of March 31, 2011 and December 31, 2010, respectively.

Table of Contents

Using the assumptions and data in effect as of March 31, 2011, we estimate that a 100 basis point immediate, parallel increase in interest rates increases the net fair value of our portfolio by approximately \$748.4 million, compared with an estimated \$455.4 million increase as of December 31, 2010. The following table details the estimated changes by risk management strategy. The table also gives the weighted-average duration of the asset portfolio for each category, and the net duration gap (i.e., the weighted-average difference between the asset and liability durations).

Risk Management Strategy	March 31, 2011			
	Value of total assets (in millions)	Duration of assets	Net duration gap	Net fair value change (in millions)
Primary duration-managed	\$ 26,155.7	3.56	(0.43)	\$ 112.5
Duration-monitored	24,733.2	4.24	(2.57)	635.9
Non duration-managed	5,054.0	4.13	N/A	N/A
Total	\$ 55,942.9			\$ 748.4

Our selection of a 100 basis point immediate, parallel increase or decrease in interest rates is a hypothetical rate scenario we use to demonstrate potential risk. While a 100 basis point immediate, parallel increase does not represent our view of future market changes, it is a near term reasonably possible hypothetical change that illustrates the potential impact of such events. While these fair value measurements provide a representation of interest rate sensitivity, they are based on our portfolio exposures at a point in time and may not be representative of future market results. These exposures will change as a result of ongoing portfolio transactions in response to new business, management's assessment of changing market conditions and available investment opportunities.

**Debt Issued and Outstanding.** The primary risk for our long-term borrowings is interest rate risk at the time of maturity or early redemption, when we may be required to refinance these obligations. We continue to monitor the interest rate environment and to evaluate refinancing opportunities as maturity dates approach.

The aggregate fair value of long-term debt, excluding accrued interest, was \$1,765.5 million and \$1,756.3 million, as of March 31, 2011 and December 31, 2010, respectively. As of March 31, 2011, a 100 basis point immediate, parallel decrease in interest rates would increase the fair value of debt by approximately \$144.0 million, as compared to an estimated \$143.1 million increase as of December 31, 2010. As of March 31, 2011, a 100 basis point immediate, parallel increase in interest rates would decrease the fair value of debt by approximately \$128.8 million, as compared to an estimated \$128.4 million decrease as of December 31, 2010. Debt is not recorded at fair value on the consolidated statements of financial position.

Our selection of a 100 basis point immediate, parallel increase or decrease in interest rates is a hypothetical rate scenario we use to demonstrate potential risk. While a 100 basis point immediate, parallel increase or decrease does not represent our view of future market changes, it is a near term reasonably possible hypothetical change that illustrates the potential impact of such events. While these fair value measurements provide a representation of interest rate sensitivity, they are based on our long-term debt obligations at a point in time and may not be representative of future obligations. These exposures will change as a result of ongoing changes to our outstanding long-term debt obligations.

**Use of Derivatives to Manage Interest Rate Risk.** We use or have previously used various derivative financial instruments to manage our exposure to fluctuations in interest rates, including interest rate swaps, interest rate collars, swaptions and futures. We use interest rate swaps and futures contracts to hedge changes in interest rates subsequent to the issuance of an insurance liability, such as a guaranteed investment contract, but prior to the purchase of a supporting asset, or during periods of holding assets in anticipation of near term liability sales. We use interest rate

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

swaps primarily to more closely match the interest rate characteristics of assets and liabilities. They can be used to change the sensitivity to the interest rate of specific assets and liabilities as well as an entire portfolio. We use interest rate collars to manage interest rate risk related to guaranteed minimum interest rate liabilities in our individual annuities contracts. We purchase swaptions to offset existing exposures.

Derivatives in our portfolio with interest rate sensitivity were in a net liability position with a fair value of \$296.3 million and \$309.9 million as of March 31, 2011 and December 31, 2010, respectively. The following table shows the interest rate sensitivity of our derivatives measured in terms of fair value. These exposures will change as a result of ongoing portfolio and risk management activities.

Table of Contents

	Notional amount	Weighted average term (years) (1)	March 31, 2011		
			-100 basis point change (\$ in millions)	Fair value (no accrued interest)	
				No change	+100 basis point change
Interest rate swaps	\$ 20,050.6	5.12	\$ (364.0)	\$ (297.5)	\$ (224.0)
Interest rate collars	500.0	11.91	13.3	1.1	(7.6)
Swaptions	68.5	0.92			0.3
Futures (2)	336.3	0.26	(13.9)	0.1	14.1
Total	\$ 20,955.4		\$ (364.6)	\$ (296.3)	\$ (217.2)

(1) Based on maturity date.

(2) We use U.S. Treasury futures to manage our over/under commitment position, and our position in these contracts changes daily.

Our selection of a 100 basis point immediate, parallel increase or decrease in interest rates is a hypothetical rate scenario we use to determine potential risk. While a 100 basis point immediate, parallel increase or decrease does not represent our view of future market changes, it is a near term reasonably possible hypothetical change that illustrates the potential impact of such events. While these fair value measurements provide a representation of interest rate sensitivity, they are based on our derivative portfolio exposures at a point in time and may not be representative of future market results. These exposures will change as a result of ongoing derivative transactions.

### Foreign Currency Risk

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from foreign currency-denominated funding agreements issued to nonqualified institutional investors in the international market, foreign currency-denominated fixed maturities and our international operations.

We estimate that as of March 31, 2011, a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we are exposed would result in no material change to the net fair value of our foreign currency denominated instruments identified above because we effectively hedge foreign currency denominated instruments to minimize exchange rate impacts, which is consistent with our estimate as of December 31, 2010. However, fluctuations in foreign currency exchange rates do affect the translation of operating earnings and equity of our international operations into our consolidated financial statements.

For our Principal International segment, we estimate that a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we were exposed would have resulted in a \$167.2 million, or 10%, reduction in the total equity excluding noncontrolling interests of our international operations as of March 31, 2011, as compared to an estimated \$161.6 million, or 10%, reduction as of December 31, 2010. We estimate that a 10% unfavorable change in the average foreign currency exchange rates to which we were exposed through our international operations would have resulted in a \$3.4 million, or 12%, reduction in the operating earnings of our international operations for the three months ended March 31, 2011, as compared to an estimated \$4.1 million, or 11%, reduction for the three months ended March 31, 2010.

The selection of a 10% immediate unfavorable change in all currency exchange rates should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event. These exposures will change as a result of a change in the size and mix of our foreign operations.

**Use of Derivatives to Manage Foreign Currency Risk.** The foreign currency risk on funding agreements and fixed maturities is mitigated by using currency swaps that swap the foreign currency interest and principal payments to our functional currency. The notional amount of our currency swap agreements associated with foreign-denominated liabilities was \$2,784.1 million and \$2,995.4 million as of March 31, 2011 and December 31, 2010, respectively. The notional amount of our currency swap agreements associated with foreign-denominated fixed maturities was \$1,494.1 million and \$1,558.5 million as of March 31, 2011 and December 31, 2010, respectively.

Table of Contents

With regard to our international operations, we attempt to do as much of our business as possible in the functional currency of the country of operation. At times, however, we are unable to do so, and in these cases, we use foreign exchange derivatives to economically hedge the resulting risks. Our operations in Chile had currency swaps with a notional amount of \$88.2 million and \$61.3 million as of March 31, 2011 and December 31, 2010, respectively, which were used to swap cash flows on U.S. dollar-denominated bonds to a local currency. Chile also utilized currency forwards with a notional amount of \$70.1 million and \$72.3 million as of March 31, 2011 and December 31, 2010, respectively, in order to mitigate currency exposure related to bonds denominated in currencies other than Chilean pesos.

Additionally, from time to time we take measures to hedge our net equity investments in our foreign subsidiaries from currency risks. There were no outstanding net equity investment hedges in 2011 or 2010.

**Equity Risk**

Equity risk is the risk that we will incur economic losses due to adverse fluctuations in a particular common stock. As of March 31, 2011 and December 31, 2010, the fair value of our equity securities was \$565.5 million and \$486.8 million, respectively. As of March 31, 2011, a 10% decline in the value of the equity securities would result in an unrealized loss of \$56.6 million, as compared to an estimated unrealized loss of \$48.7 million as of December 31, 2010.

We are also exposed to the risk that asset-based fees decrease as a result of declines in assets under management due to change in investment prices and the risk that asset management fees calculated by reference to performance could be lower. We estimate that an immediate 10% decline in the Standard & Poor's index, followed by a 2% per quarter increase would reduce our annual operating earnings by approximately four to six percent. The risk of decreased asset-based and asset management fees could also impact our estimates of total gross profits used as a basis for amortizing deferred policy acquisition costs and other actuarial balances.

The selection of a 10% unfavorable change in the equity markets should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event. Our exposure will change as a result of changes in our mix of business.

We also have equity risk associated with (1) fixed deferred annuity contracts that credit interest to customers based on changes in an external equity index; (2) variable annuity contracts that have a GMWB rider that allows the customer to receive at least the principal deposit back through withdrawals of a specified annual amount, even if the account value is reduced to zero; (3) variable annuity contracts that have a guaranteed minimum death benefit ( GMDB ) that allows the death benefit to be paid, even if the account value has fallen below the GMDB amount; (4) investment-type contracts in which the return is tied to an external equity index and (5) investment-type contracts in which the return is subject to minimum contractual guarantees. We are also subject to equity risk based upon the assets that support our benefit plans.

**Use of Derivatives to Manage Equity Risk.** We economically hedge the fixed deferred annuity product, where the interest credited is linked to an external equity index, by purchasing options that match the product's profile. We economically hedge the GMWB exposure, which includes interest rate risk and equity risk, using futures, options and interest rate swaps. We economically hedge the investment contract exposure to an external equity index using equity call options.

## Edgar Filing: PRINCIPAL FINANCIAL GROUP INC - Form 10-Q

The fair value of both the GMWB embedded derivative and associated hedging instruments are sensitive to financial market conditions and the variance related to the change in fair value of these items for a given period is largely dependent on market conditions at the end of the period. We recognized a pre-tax gain (loss) on the derivatives used to economically hedge our GMWB market risk of \$(32.2) million and \$(16.7) million for the three months ended March 31, 2011 and 2010, respectively. We recognized a pre-tax gain (loss) on the change in fair value of the GMWB embedded derivative that is primarily related to market risk impacts of \$22.9 million and \$14.1 million for the three months ended March 31, 2011 and 2010, respectively. Additionally, we recognized a pre-tax gain (loss) on the change in value of the GMWB liability, including the embedded derivative, of \$(26.8) million and \$(3.6) million for the three months ended March 31, 2011 and 2010, respectively, primarily related to incorporating a spread reflecting our own creditworthiness. We reflect the actual and expected changes in value of the GMWB embedded derivative and the associated hedging instruments in our estimated gross profits, which resulted in a pre-tax increase (decrease) in DPAC amortization of \$(18.6) million and \$10.3 million for the three months ended March 31, 2011 and 2010, respectively.

Table of Contents

**Credit Risk**

Credit risk relates to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest. Our ability to manage credit risk is essential to our business and our profitability. See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Investments for additional information about credit risk.

**Use of Derivatives to Diversify or Hedge Credit Risk.** We purchase credit default swaps to hedge credit exposures in our investment portfolio. We sell credit default swaps to offer credit protection to investors. When selling credit protection, if there is an event of default by the referenced name, we are obligated to pay the counterparty the referenced amount of the contract and receive in return the referenced security. For further information on credit derivatives sold, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 4, Derivative Financial Instruments under the caption, Credit Derivatives Sold.

We economically hedged credit exposure in our portfolio by purchasing credit default swaps with a notional amount of \$444.5 million and \$374.5 million as of March 31, 2011 and December 31, 2010, respectively. We had credit exposure through credit default swaps with a notional amount of \$150.0 million and \$140.0 million as of March 31, 2011 and December 31, 2010, respectively, by investing in various tranches of synthetic collateralized debt obligations. In addition, we sold credit default swaps creating replicated assets with a notional amount of \$926.6 million and \$967.9 million as of March 31, 2011 and December 31, 2010, respectively.

**Derivative Counterparty Risk**

In conjunction with our use of derivatives, we are exposed to counterparty risk, or the risk that the counterparty fails to perform the terms of the derivative contract. We actively manage this risk by:

- obtaining approval of all new counterparties by the Investment Committee;
- establishing exposure limits that take into account non-derivative exposure we have with the counterparty as well as derivative exposure;
- performing similar credit analysis prior to approval on each derivatives counterparty that we do when lending money on a long-term basis;
- diversifying our risk across numerous approved counterparties;



- implementing credit support annex (collateral) agreements ( CSAs ) with majority of counterparties to further limit counterparty exposures, which provide for netting of exposures;
- limiting exposure to A+ credit or better for counterparties without CSAs;
- conducting stress-test analysis to determine the maximum exposure created during the life of a prospective transaction and
- daily monitoring of counterparty credit ratings, exposures and associated collateral levels.

We believe the risk of incurring losses due to nonperformance by our counterparties is manageable. For further information on derivatives, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 4, Derivative Financial Instruments.

Based on our accounting policy, our disclosed exposure measures the fair value of derivatives that have become favorable to us and, therefore, is a combined credit exposure if all of the involved counterparties failed to fulfill their obligations. In the hypothetical scenario where all of our counterparties fail to fulfill their obligations, our exposure would be \$1,120.3 million; however, including collateral received our exposure would be reduced to \$867.0 million at March 31, 2011. For further information on derivative exposure, see Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 4, Derivative Financial Instruments under the caption, Exposure.

Table of Contents

We manage our exposure on a net basis, whereby we net positive and negative exposures for each counterparty with agreements in place. Netting positive and negative exposures would yield an exposure of \$316.8 million, which is reduced to \$63.5 million with pledged collateral at March 31, 2011. As of March 31, 2011, we held total collateral of \$253.3 million in the form of cash and securities and we posted \$320.5 million in cash and securities as collateral to our counterparties. We have not incurred any material losses on derivative financial instruments due to counterparty nonperformance. As a result of our management of our counterparty risk and the collateralization of our derivative portfolio, any deterioration in our derivative counterparties' credit would not materially impact our financial statements as of March 31, 2011.

**Item 4. Controls and Procedures**

**Changes in Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Disclosure Controls and Procedures**

In order to ensure that the information that we must disclose in our filings with the SEC is recorded, processed, summarized and reported on a timely basis, we have adopted disclosure controls and procedures. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file with or submit to the SEC is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Our Chief Executive Officer, Larry D. Zimpleman, and our Chief Financial Officer, Terrance J. Lillis, have reviewed and evaluated our disclosure controls and procedures as of March 31, 2011, and have concluded that our disclosure controls and procedures are effective.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

Disclosure concerning material legal proceedings can be found in Part I, Item 1. Financial Statements, Notes to Unaudited Consolidated Financial Statements, Note 7, Contingencies, Guarantees and Indemnifications under the caption, Litigation and Regulatory Contingencies, which is incorporated here by this reference.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, consideration should be given to the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010. If any of those factors were to occur, they could materially adversely affect our business, financial condition or future results, and could cause actual results to differ materially from those expressed in forward-looking statements in this report. There have been no material changes with respect to the risk factors discussed in our Annual Report on Form 10-K for the year ended December 31, 2010.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table presents the amount of our common share purchase activity for the periods indicated.

**Issuer Purchases of Equity Securities**

Period		Total number of shares (or units) purchased (1)	Average price paid per share (or unit)	Total number of shares (or units) purchased as part of publicly announced plans or programs	Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs (in millions) (2)
January 1, 2011	January 31, 2011	925	\$ 25.75	\$	250.0
February 1, 2011	February 28, 2011	412	\$ 32.77	\$	250.0
March 1, 2011	March 31, 2011	175,259	\$ 33.82	\$	250.0
Total		176,596			

(1) Reflects the number of shares of common stock utilized to execute certain stock incentive awards in 2011.

(2) During November 2007, our Board of Directors authorized a share repurchase program of up to \$500.0 million of our outstanding common stock. As of March 31, 2011, \$250.0 million remained under the November 2007 authorization. We suspended purchases of our common stock effective October 13, 2008, under the existing share repurchase program.

Table of Contents

**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>
12	Statement Regarding Computation of Ratio of Earnings to Fixed Charges
31.1	Certification of Larry D. Zimpleman
31.2	Certification of Terrance J. Lillis
32.1	Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code Larry D. Zimpleman
32.2	Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code Terrance J. Lillis
101	The following materials from Principal Financial Group, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Financial Position, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to Consolidated Financial Statements.

Table of Contents

**SIGNATURE**

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

PRINCIPAL FINANCIAL GROUP, INC.

Dated: May 4, 2011

By

/s/ Terrance J. Lillis  
Terrance J. Lillis  
Senior Vice President and Chief Financial Officer

Duly Authorized Officer, Principal Financial Officer,  
and Chief Accounting Officer

Table of Contents

**Exhibit Index**

<b>Exhibit Number</b>	<b>Description</b>
12	Statement Regarding Computation of Ratio of Earnings to Fixed Charges
31.1	Certification of Larry D. Zimpleman
31.2	Certification of Terrance J. Lillis
32.1	Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code Larry D. Zimpleman
32.2	Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code Terrance J. Lillis
101	The following materials from Principal Financial Group, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Financial Position, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Stockholders Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to Consolidated Financial Statements.