

PRINCIPAL FINANCIAL GROUP INC

Form 10-Q

July 30, 2014

[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 June 30, 2014

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.

(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

Smaller reporting company

(Do not check if a 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 July 23, 2014, was 293,906,026.

Table of Contents

PRINCIPAL FINANCIAL GROUP, INC.

TABLE OF CONTENTS

	Page
<u>Part I - FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	
<u>Financial Statements</u>	3
<u>Consolidated Statements of Financial Position at June 30, 2014 (Unaudited) and December 31, 2013</u>	3
<u>Unaudited Consolidated Statements of Operations for the three and six months ended June 30, 2014 and 2013</u>	4
<u>Unaudited Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2014 and 2013</u>	5
<u>Unaudited Consolidated Statements of Stockholders' Equity for the six months ended June 30, 2014 and 2013</u>	6
<u>Unaudited Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013</u>	7
<u>Notes to Unaudited Consolidated Financial Statements - June 30, 2014</u>	8
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	90
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	125
<u>Item 4.</u>	
<u>Controls and Procedures</u>	131
<u>Part II - OTHER INFORMATION</u>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	132
<u>Item 1A.</u>	
<u>Risk Factors</u>	132
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	132
<u>Item 6.</u>	
<u>Exhibits</u>	133
<u>Signature</u>	134

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

	June 30, 2014 (Unaudited)	December 31, 2013
	(in millions)	
Assets		
Fixed maturities, available-for-sale (2014 and 2013 include \$288.4 million and \$272.0 million related to consolidated variable interest entities)	\$ 50,273.6	\$ 48,757.1
Fixed maturities, trading (2014 and 2013 both include \$110.4 million related to consolidated variable interest entities)	647.8	563.1
Equity securities, available-for-sale	117.4	110.5
Equity securities, trading (2014 and 2013 include \$344.9 million and \$327.2 million related to consolidated variable interest entities)	805.8	716.9
Mortgage loans	11,592.1	11,533.6
Real estate	1,314.4	1,271.6
Policy loans	836.1	859.7
Other investments (2014 and 2013 include \$56.1 million and \$68.1 million related to consolidated variable interest entities and \$134.6 million and \$142.9 million measured at fair value under the fair value option)	3,027.2	2,944.4
Total investments	68,614.4	66,756.9
Cash and cash equivalents	1,742.3	2,371.8
Accrued investment income	497.1	532.1
Premiums due and other receivables	1,232.3	1,241.0
Deferred acquisition costs	3,028.8	3,077.0
Property and equipment	574.0	500.7
Goodwill	1,085.3	1,100.3
Other intangibles	1,418.5	1,459.0
Separate account assets (2014 and 2013 include \$34,632.1 million and \$32,824.7 million related to consolidated variable interest entities)	139,088.0	130,018.4
Other assets	1,041.6	1,134.2
Total assets	\$ 218,322.3	\$ 208,191.4
Liabilities		
Contractholder funds	\$ 35,188.4	\$ 35,958.3
Future policy benefits and claims	23,636.5	22,626.2
Other policyholder funds	833.5	758.9
Short-term debt	148.6	150.6
Long-term debt	2,529.4	2,601.4
Income taxes currently payable	9.3	5.2
Deferred income taxes	1,080.4	824.0
Separate account liabilities (2014 and 2013 include \$34,632.1 million and \$32,824.7 million related to consolidated variable interest entities)	139,088.0	130,018.4
	5,066.5	5,224.2

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

Other liabilities (2014 and 2013 include \$355.9 million and \$342.4 million related to consolidated variable interest entities, of which \$99.2 million and \$104.9 million are measured at fair value under the fair value option)

Total liabilities	207,580.6	198,167.2
Redeemable noncontrolling interest	282.4	247.2
Stockholders' equity		
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 2014 and 2013		
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 2014 and 2013	0.1	0.1
Common stock, par value \$.01 per share 2,500.0 million shares authorized, 461.2 million and 459.3 million shares issued, and 293.8 million and 295.2 million shares outstanding in 2014 and 2013	4.6	4.6
Additional paid-in capital	9,839.2	9,798.9
Retained earnings	5,816.3	5,405.4
Accumulated other comprehensive income	599.4	183.2
Treasury stock, at cost (167.4 million and 164.1 million shares in 2014 and 2013)	(5,857.8)	(5,708.0)
Total stockholders' equity attributable to Principal Financial Group, Inc.	10,401.8	9,684.2
Noncontrolling interest	57.5	92.8
Total stockholders' equity	10,459.3	9,777.0
Total liabilities and stockholders' equity	\$ 218,322.3	\$ 208,191.4

See accompanying notes.

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

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
	(in millions, except per share data)			
Revenues				
Premiums and other considerations	\$ 835.4	\$ 737.2	\$ 1,639.0	\$ 1,431.9
Fees and other revenues	855.5	803.8	1,685.2	1,537.4
Net investment income	829.0	749.7	1,673.7	1,539.0
Net realized capital gains (losses), excluding impairment losses on available-for-sale securities	109.7	(53.4)	129.5	(79.8)
Net other-than-temporary impairment (losses) recoveries on available-for-sale securities	14.9	(24.6)	25.8	(69.3)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income	(37.8)	(2.1)	(67.9)	18.1
Net impairment losses on available-for-sale securities	(22.9)	(26.7)	(42.1)	(51.2)
Net realized capital gains (losses)	86.8	(80.1)	87.4	(131.0)
Total revenues	2,606.7	2,210.6	5,085.3	4,377.3
Expenses				
Benefits, claims and settlement expenses	1,268.4	1,095.7	2,495.9	2,190.2
Dividends to policyholders	44.6	47.5	90.3	95.8
Operating expenses	886.2	801.8	1,715.2	1,597.5
Total expenses	2,199.2	1,945.0	4,301.4	3,883.5
Income before income taxes	407.5	265.6	783.9	493.8
Income taxes	88.3	29.0	140.6	67.2
Net income	319.2	236.6	643.3	426.6
Net income attributable to noncontrolling interest	4.6	6.0	26.8	9.5
Net income attributable to Principal Financial Group, Inc.	314.6	230.6	616.5	417.1
Preferred stock dividends	8.3	8.3	16.5	16.5
Net income available to common stockholders	\$ 306.3	\$ 222.3	\$ 600.0	\$ 400.6
Earnings per common share				
Basic earnings per common share	\$ 1.04	\$ 0.76	\$ 2.00	\$ 1.36
Diluted earnings per common share	\$ 1.03	\$ 0.75	\$ 1.98	\$ 1.35
Dividends declared per common share	\$ 0.32	\$ 0.23	\$ 0.60	\$ 0.46

See accompanying notes.

Table of Contents**Principal Financial Group, Inc.****Consolidated Statements of Comprehensive Income****(Unaudited)**

	For the three months ended		For the six months ended	
	2014	June 30, 2013	2014	June 30, 2013
	(in millions)			
Net income	\$ 319.2	\$ 236.6	\$ 643.3	\$ 426.6
Other comprehensive income (loss), net:				
Net unrealized gains (losses) on available-for-sale securities	178.3	(453.7)	370.5	(553.0)
Noncredit component of impairment losses on fixed maturities, available-for-sale	20.4	0.7	37.9	(10.6)
Net unrealized gains (losses) on derivative instruments	4.1	(0.3)	13.1	21.7
Foreign currency translation adjustment	33.0	(190.4)	(12.6)	(136.0)
Net unrecognized postretirement benefit obligation	3.6	13.8	7.1	27.6
Other comprehensive income (loss)	239.4	(629.9)	416.0	(650.3)
Comprehensive income (loss)	558.6	(393.3)	1,059.3	(223.7)
Comprehensive income (loss) attributable to noncontrolling interest	6.4	(2.4)	26.6	
Comprehensive income (loss) attributable to Principal Financial Group, Inc.	\$ 552.2	\$ (390.9)	\$ 1,032.7	\$ (223.7)

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)								
Balances at January 1, 2013	\$	\$ 0.1	\$ 4.5	\$ 9,730.9	\$ 4,862.0	\$ 640.3	\$ (5,554.4)	\$ 20.0	\$ 9,703.4
Common stock issued			0.1	37.7					37.8
Stock-based compensation and additional related tax benefits				38.1	(2.2)				35.9
Treasury stock acquired, common							(91.4)		(91.4)
Dividends to common stockholders					(135.2)				(135.2)
Dividends to preferred stockholders					(16.5)				(16.5)
Distributions to noncontrolling interest								(6.4)	(6.4)
Contributions from noncontrolling interest								115.9	115.9
Purchase of subsidiary shares from noncontrolling interest				1.6				(47.2)	(45.6)
Sale of subsidiary shares to noncontrolling interest				11.5				20.3	31.8
Net income (excludes \$1.1 million attributable to redeemable noncontrolling interest)					417.1			8.4	425.5
Other comprehensive loss (excludes \$(4.0) million attributable to redeemable noncontrolling interest)						(640.8)		(5.5)	(646.3)
Balances at June 30, 2013	\$	\$ 0.1	\$ 4.6	\$ 9,819.8	\$ 5,125.2	\$ (0.5)	\$ (5,645.8)	\$ 105.5	\$ 9,408.9
Balances at January 1, 2014	\$	\$ 0.1	\$ 4.6	\$ 9,798.9	\$ 5,405.4	\$ 183.2	\$ (5,708.0)	\$ 92.8	\$ 9,777.0
Common stock issued				26.1					26.1
Stock-based compensation and additional related tax benefits				41.7	(2.9)				38.8
Treasury stock acquired, common							(149.8)		(149.8)
Dividends to common stockholders					(176.8)				(176.8)
Dividends to preferred stockholders					(16.5)				(16.5)
Distributions to noncontrolling interest								(22.3)	(22.3)
Contributions from noncontrolling interest								8.2	8.2
Purchase of subsidiary shares from noncontrolling interest				(0.4)				(39.7)	(40.1)
Adjustments to redemption amount of redeemable noncontrolling interest				(27.1)	(9.4)				(36.5)
Net income (excludes \$5.2 million attributable to redeemable noncontrolling interest)					616.5			21.6	638.1
Other comprehensive income (excludes \$2.9 million attributable to redeemable noncontrolling interest)						416.2		(3.1)	413.1
Balances at June 30, 2014	\$	\$ 0.1	\$ 4.6	\$ 9,839.2	\$ 5,816.3	\$ 599.4	\$ (5,857.8)	\$ 57.5	\$ 10,459.3

See accompanying notes.

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

	For the six months ended June 30,	
	2014	2013
	(in millions)	
Operating activities		
Net income	\$ 643.3	\$ 426.6
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred acquisition costs	143.0	101.6
Additions to deferred acquisition costs	(193.6)	(236.6)
Accrued investment income	35.0	19.0
Net cash flows for trading securities	(86.5)	(27.4)
Premiums due and other receivables	50.9	(44.5)
Contractholder and policyholder liabilities and dividends	829.4	461.6
Current and deferred income taxes	114.3	136.3
Net realized capital (gains) losses	(87.4)	131.0
Depreciation and amortization expense	81.5	75.2
Mortgage loans held for sale, sold or repaid, net of gain	8.4	0.2
Real estate acquired through operating activities	(35.5)	(54.3)
Real estate sold through operating activities	146.0	11.6
Stock-based compensation	39.3	36.2
Other	(310.8)	(252.9)
Net adjustments	734.0	357.0
Net cash provided by operating activities	1,377.3	783.6
Investing activities		
Available-for-sale securities:		
Purchases	(4,593.1)	(4,921.6)
Sales	1,385.6	1,099.4
Maturities	2,966.0	3,955.4
Mortgage loans acquired or originated	(956.9)	(1,778.4)
Mortgage loans sold or repaid	865.2	1,079.9
Real estate acquired	(193.9)	(46.9)
Net purchases of property and equipment	(93.3)	(11.9)
Purchase of interests in subsidiaries, net of cash acquired		(1,268.3)
Net change in other investments	123.8	(30.2)
Net cash used in investing activities	(496.6)	(1,922.6)
Financing activities		
Issuance of common stock	26.1	37.8
Acquisition of treasury stock	(149.8)	(91.4)
Proceeds from financing element derivatives	14.6	14.6
Payments for financing element derivatives	(25.6)	(24.3)
Excess tax benefits from share-based payment arrangements	5.8	6.8
Purchase of subsidiary shares from noncontrolling interest	(40.1)	(47.2)
Sale of subsidiary shares to noncontrolling interest		31.8
Dividends to common stockholders	(176.8)	(135.2)
Dividends to preferred stockholders	(16.5)	(8.2)
Issuance of long-term debt	27.4	9.1
Principal repayments of long-term debt	(100.1)	(211.9)
Net proceeds from (repayments of) short-term borrowings	(0.3)	131.7

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

Investment contract deposits	2,648.1		3,157.3
Investment contract withdrawals	(3,701.3)		(4,771.4)
Net decrease in banking operation deposits	(15.3)		(23.8)
Other	(6.4)		(3.4)
Net cash used in financing activities	(1,510.2)		(1,927.7)
Net decrease in cash and cash equivalents	(629.5)		(3,066.7)
Cash and cash equivalents at beginning of period	2,371.8		4,177.2
Cash and cash equivalents at end of period	\$ 1,742.3	\$	1,110.5

See accompanying notes.

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements

June 30, 2014

(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 and six months ended June 30, 2014, are not necessarily indicative of the results that may be expected for the year ended December 31, 2014. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2013, included in our Form 10-K for the year ended December 31, 2013, filed with the United States Securities and Exchange Commission (SEC). The accompanying consolidated statement of financial position as of December 31, 2013, 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 June 2014, the Financial Accounting Standards Board (FASB) issued authoritative guidance that a performance target in a share-based payment that affects vesting and that could be achieved after the requisite service period, should be accounted for as a performance condition. This guidance will be effective for us on January 1, 2016, with early adoption permitted. This guidance is not expected to have a material impact on our consolidated financial statements.

Also in June 2014, the FASB issued authoritative guidance that amends current accounting and disclosures for repurchase agreements and similar transactions. This guidance will be effective for us on January 1, 2015, and is not expected to have a material impact on our consolidated financial statements.

In May 2014, the FASB issued authoritative guidance on revenue recognition that replaces all general and most industry specific revenue guidance currently prescribed by U.S. GAAP. The core principle of the revenue standard is that an entity recognizes revenue to reflect the transfer of a promised good or service to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for that good or service. The guidance will be effective for us on January 1, 2017, and early adoption is not permitted. An entity may apply the new guidance using one of the following two methods: (1) retrospectively to each prior reporting period presented, or

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

(2) retrospectively with the cumulative effect of initially applying the standard recognized at the date of initial application. We are currently evaluating the impact this guidance will have on our consolidated financial statements.

In April 2014, the FASB issued authoritative guidance related to discontinued operations which amends the definition of a discontinued operation and requires entities to provide additional disclosures associated with discontinued operations, as well as disposal transactions that do not meet the discontinued operations criteria. The guidance requires discontinued operations treatment for disposals of a component or group of components that represents a strategic shift that has or will have a major impact on an entity's operations or financial results. The guidance also expands the scope to disposals of equity method investments and businesses that, upon initial acquisition, qualify as held for sale. This guidance will be effective for us beginning January 1, 2015, and early adoption is permitted. We are currently evaluating the impact this guidance will have on our consolidated financial statements.

In January 2014, the FASB issued authoritative guidance to reduce diversity in practice by clarifying when an in substance repossession or foreclosure occurs. This guidance will be effective for us beginning January 1, 2015, and is not expected to have a material impact on our consolidated financial statements.

Also, in January 2014, the FASB issued authoritative guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. This guidance will be effective for us beginning January 1, 2015, and is not expected to have a material impact on our consolidated financial statements.

In July 2013, the FASB issued authoritative guidance that requires the liability related to certain unrecognized benefits to be offset against a deferred tax asset from operating loss carryforwards. This guidance was effective for us beginning January 1, 2014, and did not have a material impact on our consolidated financial statements.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

In June 2013, the FASB issued authoritative guidance that formalizes the definition of an investment company. This guidance was effective for us beginning January 1, 2014, and did not have a material impact on our consolidated financial statements.

In March 2013, the FASB issued authoritative guidance that clarifies how the cumulative translation adjustment related to a parent's investment in a foreign entity should be released when certain transactions related to the foreign entity occur. This guidance was effective prospectively for us beginning January 1, 2014, and did not have a material impact on our consolidated financial statements.

Separate Accounts

The separate accounts are legally segregated and are not subject to the claims that arise out of any of our other business. The client, rather than us, directs the investments and bears the investment risk of these funds. The separate account assets represent the fair value of funds that are separately administered by us for contracts with equity, real estate and fixed income investments and are presented as a summary total within the consolidated statements of financial position. An equivalent amount is reported as separate account liabilities, which represent the obligation to return the monies to the client. We receive fees for mortality, withdrawal and expense risks, as well as administrative, maintenance and investment advisory services that are included in the consolidated statements of operations. Net deposits, net investment income and realized and unrealized capital gains and losses of the separate accounts are not reflected in the consolidated statements of operations. Separate account assets and separate account liabilities include certain non-domestic retirement accumulation products where the segregated funds and associated obligation to the client are consolidated within our financial statements. We have determined that summary totals are the most meaningful presentation for these funds.

At June 30, 2014 and December 31, 2013, the separate account assets include a separate account valued at \$213.7 million and \$223.1 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.

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. For VIEs that are investment companies, the primary beneficiary is the enterprise who absorbs the majority of the entity's expected losses, receives a majority of the expected residual returns or both. On an ongoing basis, we assess whether we are the primary beneficiary of VIEs we have relationships with.

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 Vehicle

We invest in synthetic collateralized debt obligations, collateralized bond obligations, collateralized loan 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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 and the notes due at maturity or termination of the trusts. We determined we are the primary beneficiary for one of these entities because we act as the investment manager of the underlying portfolio and we have an ownership interest.

Commercial Mortgage-Backed Securities

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 that controls the unilateral kick out rights of the special servicer.

Mandatory Retirement Savings

We hold an equity interest in Chilean mandatory privatized social security funds in which we provide asset management services. We determined that the mandatory privatized social security funds, which include contributors for voluntary pension savings, voluntary non-pension savings and compensation savings accounts, are VIEs. This is because the equity holders as a group lack the power, due to voting rights or similar rights, to direct the activities of the entity that most significantly impact the entity's economic performance and also because equity investors are protected from below-average market investment returns relative to the industry's return, due to a regulatory guarantee that we provide. Further we concluded that we are the primary beneficiary through our power to make decisions and our variable interest in the funds. The purpose of the funds, which reside in legally segregated entities, is to provide long-term retirement savings. The obligation to the client is directly related to the assets held in the funds and, as such, we present the assets as separate account assets and the obligation as separate account liabilities within our consolidated statements of financial position.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 vehicle	CMBS	Mandatory retirement savings	Total
June 30, 2014					
Fixed maturities, available-for-sale	\$ 288.4	\$	\$	\$	\$ 288.4
Fixed maturities, trading		110.4			110.4
Equity securities, trading				344.9	344.9
Other investments			56.1		56.1
Accrued investment income	0.4		0.4		0.8
Separate account assets				34,632.1	34,632.1
Total assets	\$ 288.8	\$ 110.4	\$ 56.5	\$ 34,977.0	\$ 35,432.7
Deferred income taxes	\$ 1.7	\$	\$	\$	\$ 1.7
Separate account liabilities				34,632.1	34,632.1
Other liabilities (1)	244.1	92.3	19.5		355.9
Total liabilities	\$ 245.8	\$ 92.3	\$ 19.5	\$ 34,632.1	\$ 34,989.7
December 31, 2013					
Fixed maturities, available-for-sale	\$ 272.0	\$	\$	\$	\$ 272.0
Fixed maturities, trading		110.4			110.4
Equity securities, trading				327.2	327.2
Other investments			68.1		68.1
Accrued investment income	0.3		0.6		0.9
Separate account assets				32,824.7	32,824.7
Total assets	\$ 272.3	\$ 110.4	\$ 68.7	\$ 33,151.9	\$ 33,603.3
Deferred income taxes	\$ 1.5	\$	\$	\$	\$ 1.5
Separate account liabilities				32,824.7	32,824.7
Other liabilities (1)	217.2	93.8	31.4		342.4
Total liabilities	\$ 218.7	\$ 93.8	\$ 31.4	\$ 32,824.7	\$ 33,168.6

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

We did not provide financial or other support to investees designated as VIEs for the periods ended June 30, 2014 and December 31, 2013.

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 these VIEs are reported in fixed maturities, available-for-sale; fixed maturities, trading and other investments in the consolidated statements of financial position and are described below.

Unconsolidated VIEs include CMBS, residential mortgage-backed pass-through securities (RMBS) and other asset-backed securities (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 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.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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.

We have invested in partnerships, some of which are classified as VIEs. The returns from the partnerships are in the form of income tax credits and investment income. These entities are classified as VIEs as the general partner does not have an equity investment at risk in the entity. We have determined we are not the primary beneficiary because we are not the general partner, who makes all the significant decisions for the entity or our variable interest does not absorb the majority of the variability of the entities' net assets.

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

	Asset carrying value	Maximum exposure to loss (1)
June 30, 2014		
Fixed maturities, available-for-sale:		
Corporate	\$ 493.3	\$ 390.4
Residential mortgage-backed pass-through securities	2,902.3	2,791.0
Commercial mortgage-backed securities	4,043.4	3,947.9
Collateralized debt obligations	443.5	462.0
Other debt obligations	4,305.7	4,267.2
Fixed maturities, trading:		
Residential mortgage-backed pass-through securities	39.0	39.0
Commercial mortgage-backed securities	1.5	1.5
Collateralized debt obligations	49.3	49.3
Other debt obligations	0.7	0.7
Other investments:		
Other limited partnership interests	146.9	146.9
December 31, 2013		
Fixed maturities, available-for-sale:		
Corporate	\$ 523.4	\$ 448.2
Residential mortgage-backed pass-through securities	2,845.2	2,799.1
Commercial mortgage-backed securities	4,026.4	4,078.0
Collateralized debt obligations	363.4	391.9

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

Other debt obligations	4,167.8	4,157.5
Fixed maturities, trading:		
Residential mortgage-backed pass-through securities	47.5	47.5
Commercial mortgage-backed securities	1.8	1.8
Collateralized debt obligations	59.6	59.6
Other debt obligations	1.2	1.2
Other investments:		
Other limited partnership interests	123.5	123.5

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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 June 30, 2014 and December 31, 2013, these VIEs held \$1.3 billion and \$1.4 billion, respectively, in total assets. We have no contractual obligation to contribute to the funds.

We provide asset management and other services to certain investment structures that are considered VIEs as we generally earn performance-based management 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 securities. Equity securities include mutual funds, common stock, nonredeemable preferred stock and mandatory regulatory required investments. 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 acquisition costs (DAC), sales inducements, unearned revenue reserves, policyholder liabilities, 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 have assets within the trading securities portfolio that represent mandatory regulatory required investments. 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. 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
June 30, 2014
(Unaudited)

The amortized cost, gross unrealized gains and losses, other-than-temporary impairments in accumulated other comprehensive income (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	Fair value	Other-than- temporary impairments in AOCI (1)
June 30, 2014					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 773.4	\$ 17.5	\$ 10.6	\$ 780.3	\$
Non-U.S. governments	795.1	186.8	1.9	980.0	
States and political subdivisions	3,900.6	226.7	21.0	4,106.3	
Corporate	30,231.1	2,612.9	131.9	32,712.1	19.5
Residential mortgage-backed pass-through securities	2,791.0	124.9	13.6	2,902.3	
Commercial mortgage-backed securities	3,947.9	185.3	89.8	4,043.4	118.5
Collateralized debt obligations	462.0	6.6	25.1	443.5	0.7
Other debt obligations	4,267.2	64.3	25.8	4,305.7	70.9
Total fixed maturities, available-for-sale	\$ 47,168.3	\$ 3,425.0	\$ 319.7	\$ 50,273.6	\$ 209.6
Total equity securities, available-for-sale	\$ 119.0	\$ 8.0	\$ 9.6	\$ 117.4	
December 31, 2013					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 818.2	\$ 12.7	\$ 50.4	\$ 780.5	\$
Non-U.S. governments	853.2	148.8	5.2	996.8	
States and political subdivisions	3,622.8	120.9	85.7	3,658.0	
Corporate	30,280.6	1,958.8	320.4	31,919.0	17.1
Residential mortgage-backed pass-through securities	2,799.1	92.8	46.7	2,845.2	
Commercial mortgage-backed securities	4,078.0	170.6	222.2	4,026.4	183.4
Collateralized debt obligations	391.9	6.0	34.5	363.4	0.7
Other debt obligations	4,157.5	51.8	41.5	4,167.8	76.3
Total fixed maturities, available-for-sale	\$ 47,001.3	\$ 2,562.4	\$ 806.6	\$ 48,757.1	\$ 277.5
Total equity securities, available-for-sale	\$ 113.8	\$ 10.0	\$ 13.3	\$ 110.5	

(1) Excludes \$186.5 million and \$148.6 million as of June 30, 2014 and December 31, 2013, respectively, of net unrealized gains on impaired fixed maturities, available-for-sale related to changes in fair value subsequent to the impairment date, which are included in gross unrealized gains and gross unrealized losses.

The amortized cost and fair value of fixed maturities available-for-sale at June 30, 2014, by expected maturity, were as follows:

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

	Amortized cost	Fair value
Due in one year or less	\$ 3,153.3	\$ 3,199.7
Due after one year through five years	12,340.1	13,022.7
Due after five years through ten years	8,682.9	9,329.7
Due after ten years	11,523.9	13,026.6
Subtotal	35,700.2	38,578.7
Mortgage-backed and other asset-backed securities	11,468.1	11,694.9
Total	\$ 47,168.3	\$ 50,273.6

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.

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 addition to realized capital gains and losses on investment sales and periodic settlements on derivatives not designated as hedges, we report gains and

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

losses related to the following in net realized capital gains (losses): other-than-temporary impairments of securities and subsequent realized 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 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 represent mandatory required investments 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 June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Fixed maturities, available-for-sale:				
Gross gains	\$ 51.9	\$ 6.3	\$ 64.2	\$ 21.8
Gross losses	(16.1)	(29.7)	(23.0)	(80.4)
Other-than-temporary impairment losses reclassified to (from) OCI	(37.8)	(2.1)	(67.9)	18.1
Hedging, net	(3.0)	(60.8)	1.5	(89.8)
Fixed maturities, trading	8.3	(6.3)	22.5	(6.2)
Equity securities, available-for-sale:				
Gross gains		0.1	5.8	0.1
Gross losses		(0.1)		(0.1)
Equity securities, trading	6.0	5.2	9.6	11.5
Mortgage loans		(10.8)	1.4	(17.0)
Derivatives	15.2	11.8	3.9	30.0
Other	62.3	6.3	69.4	(19.0)
Net realized capital gains (losses)	\$ 86.8	\$ (80.1)	\$ 87.4	\$ (131.0)

Proceeds from sales of investments (excluding call and maturity proceeds) in fixed maturities, available-for-sale were \$835.6 million and \$542.1 million for the three months ended June 30, 2014 and 2013, and \$1,307.5 million and \$1,102.2 million for the six months ended June 30, 2014 and 2013, 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.

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

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-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.

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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
	(in millions)			
Fixed maturities, available-for-sale	\$ 15.1	\$ (24.5)	\$ 20.1	\$ (69.2)
Equity securities, available-for-sale	(0.2)	(0.1)	5.7	(0.1)
Total other-than-temporary impairment losses, net of recoveries from the sale of previously impaired securities	14.9	(24.6)	25.8	(69.3)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) OCI (1)	(37.8)	(2.1)	(67.9)	18.1
Net impairment losses on available-for-sale securities	\$ (22.9)	\$ (26.7)	\$ (42.1)	\$ (51.2)

(1) Represents the net impact of (a) gains resulting from reclassification of noncredit impairment losses for fixed maturities with bifurcated OTTI from net realized capital gains (losses) to OCI and (b) 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
June 30, 2014
(Unaudited)

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 June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
	(in millions)			
Beginning balance	\$ (224.2)	\$ (318.6)	\$ (235.4)	\$ (335.2)
Credit losses for which an other-than-temporary impairment was not previously recognized	(3.6)	(1.9)	(3.9)	(6.2)
Credit losses for which an other-than-temporary impairment was previously recognized	(20.4)	(16.8)	(44.5)	(35.1)
Reduction for credit losses previously recognized on fixed maturities now sold, paid down or intended to be sold	60.4	32.7	94.0	68.5
Net reduction for positive changes in cash flows expected to be collected and amortization (1)	2.1	3.1	4.1	6.5
Ending balance	\$ (185.7)	\$ (301.5)	\$ (185.7)	\$ (301.5)

(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		June 30, 2014 Greater than or equal to twelve months		Total
	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	
	(in millions)				

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

Fixed maturities, available-for-sale:												
U.S. government and agencies	\$	138.4	\$	0.4	\$	227.7	\$	10.2	\$	366.1	\$	10.6
Non-U.S. governments		3.0				26.2		1.9		29.2		1.9
States and political subdivisions		128.5		0.4		550.3		20.6		678.8		21.0
Corporate		694.8		3.4		1,828.0		128.5		2,522.8		131.9
Residential mortgage-backed pass-through securities		37.4		0.1		540.1		13.5		577.5		13.6
Commercial mortgage-backed securities		158.6		1.7		524.1		88.1		682.7		89.8
Collateralized debt obligations		150.0		1.9		68.9		23.2		218.9		25.1
Other debt obligations		225.5		0.7		502.7		25.1		728.2		25.8
Total fixed maturities, available-for-sale	\$	1,536.2	\$	8.6	\$	4,268.0	\$	311.1	\$	5,804.2	\$	319.7
Total equity securities, available-for-sale	\$		\$		\$	51.7	\$	9.6	\$	51.7	\$	9.6

Of the total amounts, Principal Life Insurance Company's (Principal Life) consolidated portfolio represented \$5,552.0 million in available-for-sale fixed maturities with gross unrealized losses of \$296.4 million. Of those fixed maturity securities in Principal Life's consolidated portfolio with a gross unrealized loss position, 84% were investment grade (rated AAA through BBB-) with an average price

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

of 95 (carrying value/amortized cost) at June 30, 2014. Gross unrealized losses in our fixed maturities portfolio decreased during the six months ended June 30, 2014, due to a decrease in interest rates and spread improvements.

For those securities that had been in a continuous unrealized loss position for less than twelve months, Principal Life's consolidated portfolio held 214 securities with a carrying value of \$1,521.0 million and unrealized losses of \$8.5 million reflecting an average price of 99 at June 30, 2014. Of this portfolio, 83% was investment grade (rated AAA through BBB-) at June 30, 2014, with associated unrealized losses of \$6.8 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 603 securities with a carrying value of \$4,031.0 million and unrealized losses of \$287.9 million. The average rating of this portfolio was A with an average price of 93 at June 30, 2014. Of the \$287.9 million in unrealized losses, the commercial mortgage-backed securities sector accounts for \$88.1 million in unrealized losses with an average price of 86 and an average credit rating of BB+. The remaining unrealized losses consist primarily of \$107.0 million within the corporate sector at June 30, 2014. The average price of the corporate sector was 94 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 June 30, 2014.

	Less than twelve months		December 31, 2013 Greater than or equal to twelve months		Total	
	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses
	(in millions)					
Fixed maturities, available-for-sale:						
U.S. government and agencies	\$ 526.8	\$ 49.6	\$ 9.2	\$ 0.8	\$ 536.0	\$ 50.4
Non-U.S. governments	78.1	5.1	5.8	0.1	83.9	5.2
States and political subdivisions	1,338.6	75.3	46.1	10.4	1,384.7	85.7
Corporate	4,087.9	155.4	1,278.1	165.0	5,366.0	320.4
Residential mortgage-backed pass- through securities	1,150.3	38.2	85.9	8.5	1,236.2	46.7

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

Commercial mortgage-backed securities	683.7	15.3	495.6	206.9	1,179.3	222.2
Collateralized debt obligations	88.8	1.4	47.4	33.1	136.2	34.5
Other debt obligations	1,359.0	16.1	287.9	25.4	1,646.9	41.5
Total fixed maturities, available-for-sale	\$ 9,313.2	\$ 356.4	\$ 2,256.0	\$ 450.2	\$ 11,569.2	\$ 806.6
Total equity securities, available-for-sale	\$ 16.7	\$ 0.3	\$ 48.3	\$ 13.0	\$ 65.0	\$ 13.3

Of the total amounts, Principal Life consolidated portfolio represented \$10,905.4 million in available-for-sale fixed maturities with gross unrealized losses of \$752.5 million. Of those fixed maturity securities in Principal Life's consolidated portfolio with a gross unrealized loss position, 87% were investment grade (rated AAA through BBB-) with an average price of 94 (carrying value/amortized cost) at December 31, 2013. Gross unrealized losses in our fixed maturities portfolio decreased slightly during the year ended December 31, 2013, due to spread improvements.

For those securities that had been in a continuous unrealized loss position for less than twelve months, Principal Life's consolidated portfolio held 1,154 securities with a carrying value of \$8,899.5 million and unrealized losses of \$339.8 million reflecting an average price of 96 at December 31, 2013. Of this portfolio, 94% was investment grade (rated AAA through BBB-) at December 31, 2013, with associated unrealized losses of \$325.9 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
June 30, 2014
(Unaudited)

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 359 securities with a carrying value of \$2,005.9 million and unrealized losses of \$412.7 million. The average rating of this portfolio was BBB- with an average price of 83 at December 31, 2013. Of the \$412.7 million in unrealized losses, the commercial mortgage-backed securities sector accounts for \$206.9 million in unrealized losses with an average price of 71 and an average credit rating of BB-. The remaining unrealized losses consist primarily of \$127.6 million within the corporate sector at December 31, 2013. 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, 2013.

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 in cash flow hedge relationships 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 in cash flow hedge relationships net of adjustments related to DAC, reinsurance assets or liabilities, sales inducements, unearned revenue reserves, changes in policyholder liabilities and applicable income taxes was as follows:

	June 30, 2014	(in millions)	December 31, 2013
Net unrealized gains on fixed maturities, available-for-sale (1)	\$ 3,338.5		\$ 2,067.4
Noncredit component of impairment losses on fixed maturities, available-for-sale	(209.6)		(277.5)
Net unrealized losses on equity securities, available-for-sale	(1.6)		(3.3)
Adjustments for assumed changes in amortization patterns	(374.0)		(265.9)
Adjustments for assumed changes in policyholder liabilities	(1,212.8)		(621.2)
Net unrealized gains on derivative instruments	83.4		56.0
Net unrealized gains on equity method subsidiaries and noncontrolling interest adjustments	64.3		87.1
Provision for deferred income taxes	(566.1)		(342.0)
Net unrealized gains on available-for-sale securities and derivative instruments	\$ 1,122.1		\$ 700.6

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

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, including mezzanine 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:

	June 30, 2014		December 31, 2013
	(in millions)		
Commercial mortgage loans	\$ 10,382.9	\$	10,327.7
Residential mortgage loans	1,274.1		1,275.7
Total amortized cost	11,657.0		11,603.4
Valuation allowance	(64.9)		(69.8)
Total carrying value	\$ 11,592.1	\$	11,533.6

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

We periodically purchase mortgage loans as well as sell mortgage loans we have originated. We purchased \$40.3 million and \$22.5 million of residential mortgage loans during the three months ended June 30, 2014 and 2013, and \$80.1 million and \$71.0 million during the six months ended June 30, 2014 and 2013, respectively. We sold \$0.0 million and \$0.0 million of residential mortgage loans during the three months ended June 30, 2014 and 2013, and \$0.0 million and \$0.0 million during the six months ended June 30, 2014 and 2013, respectively. We purchased \$12.1 million and \$141.1 million of commercial mortgage loans during the three months ended June 30, 2014 and 2013, and \$33.4 million and \$141.1 million during the six months ended June 30, 2014 and 2013, respectively. We sold \$0.0 million and \$0.0 million of commercial mortgage loans during the three months ended June 30, 2014 and 2013, and \$1.1 million and \$13.0 million during the six months ended June 30, 2014 and 2013, respectively.

Our commercial mortgage loan portfolio consists primarily of non-recourse, fixed rate mortgages on stabilized properties. Our commercial mortgage loan portfolio is diversified by geographic region and specific collateral property type as follows:

	June 30, 2014		December 31, 2013	
	Amortized cost	Percent of total	Amortized cost	Percent of total
	(\$ in millions)			
Geographic distribution				
New England	\$ 525.2	5.1%	\$ 528.5	5.1%
Middle Atlantic	2,740.2	26.4	2,489.0	24.1
East North Central	494.8	4.8	519.9	5.0
West North Central	271.8	2.6	302.9	2.9
South Atlantic	1,957.9	18.9	1,949.5	18.9
East South Central	201.5	1.9	192.8	1.9
West South Central	883.5	8.5	830.3	8.0
Mountain	764.3	7.4	747.1	7.2
Pacific	2,500.3	24.0	2,722.5	26.5
International	43.4	0.4	45.2	0.4
Total	\$ 10,382.9	100.0%	\$ 10,327.7	100.0%
Property type distribution				
Office	\$ 3,518.6	33.9%	\$ 3,360.5	32.6%
Retail	2,606.1	25.1	2,668.5	25.8
Industrial	1,667.5	16.1	1,766.2	17.1
Apartments	1,966.6	18.9	1,911.2	18.5
Hotel	340.6	3.3	333.1	3.2
Mixed use/other	283.5	2.7	288.2	2.8
Total	\$ 10,382.9	100.0%	\$ 10,327.7	100.0%

Our residential mortgage loan portfolio is composed of home equity mortgages with an amortized cost of \$358.6 million and \$394.9 million and first lien mortgages with an amortized cost of \$915.5 million and \$880.8 million as of June 30, 2014 and December 31, 2013, respectively. 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 presents expected losses in terms of a Standard & Poor's (S&P) bond equivalent rating. As the credit risk for commercial mortgage loans increases, we adjust our internal ratings downward with loans in the category B+ and below having the highest risk for credit loss. 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.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 significant negative changes 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.

The amortized cost of 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	June 30, 2014 CTL (in millions)	Total
A- and above	\$ 8,461.2	\$ 183.2	\$ 8,644.4
BBB+ thru BBB-	1,259.6	207.6	1,467.2
BB+ thru BB-	151.9		151.9
B+ and below	117.6	1.8	119.4
Total	\$ 9,990.3	\$ 392.6	\$ 10,382.9

	Brick and mortar	December 31, 2013 CTL (in millions)	Total
A- and above	\$ 8,091.9	\$ 194.5	\$ 8,286.4
BBB+ thru BBB-	1,463.7	250.0	1,713.7
BB+ thru BB-	155.4	0.1	155.5
B+ and below	170.1	2.0	172.1
Total	\$ 9,881.1	\$ 446.6	\$ 10,327.7

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.

The amortized cost of our performing and non-performing residential mortgage loans was as follows:

June 30, 2014

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

	Home equity	First liens (in millions)	Total
Performing	\$ 343.0	\$ 900.3	\$ 1,243.3
Nonperforming	15.6	15.2	30.8
Total	\$ 358.6	\$ 915.5	\$ 1,274.1

	Home equity	December 31, 2013 First liens (in millions)	Total
Performing	\$ 378.3	\$ 862.1	\$ 1,240.4
Nonperforming	16.6	18.7	35.3
Total	\$ 394.9	\$ 880.8	\$ 1,275.7

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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

or number of days past due and other circumstances 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 a longer period of delinquency than domestic loans, as assessment of collectability is based on the nature of the loans and collection practices in that market.

The amortized cost of mortgage loans on non-accrual status was as follows:

	June 30, 2014	December 31, 2013
	(in millions)	
Commercial:		
Brick and mortar	\$ 4.6	\$ 33.2
Residential:		
Home equity	15.6	16.6
First liens	9.7	11.4
Total	\$ 29.9	\$ 61.2

The aging of our mortgage loans, based on amortized cost, was as follows:

	June 30, 2014				Current	Total loans	Recorded investment 90 days or more and accruing
	30-59 days past due	60-89 days past due	90 days or more past due	Total past due (in millions)			
Commercial-brick and mortar	\$	\$	\$ 0.2	\$ 0.2	\$ 9,990.1	\$ 9,990.3	\$
Commercial-CTL					392.6	392.6	
Residential-home equity	3.6	1.7	1.9	7.2	351.4	358.6	
Residential-first liens	24.8	6.0	14.2	45.0	870.5	915.5	5.5
Total	\$ 28.4	\$ 7.7	\$ 16.3	\$ 52.4	\$ 11,604.6	\$ 11,657.0	\$ 5.5

December 31, 2013

	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Current	Total loans	Recorded investment 90 days or more and accruing

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

(in millions)

Commercial-brick and mortar	\$	\$	\$	16.7	\$	16.7	\$	9,864.4	\$	9,881.1	\$		
Commercial-CTL								446.6		446.6			
Residential-home equity		4.4		1.0		3.0		8.4		386.5		394.9	
Residential-first liens		32.4		7.4		17.1		56.9		823.9		880.8	
Total	\$	36.8	\$	8.4	\$	36.8	\$	82.0	\$	11,521.4	\$	11,603.4	
												\$	7.3

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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

effective interest rate, the loan's observable market price or fair value of the collateral. 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 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.

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 risk rating level with an estimated loss ratio applied against each risk rating level. The loss ratio is generally based upon historic loss experience for each risk rating level as adjusted for certain current 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 June 30, 2014		
	Commercial	Residential (in millions)	Total
Beginning balance	\$ 26.5	\$ 40.0	\$ 66.5
Provision	(0.1)	0.5	0.4
Charge-offs		(2.6)	(2.6)
Recoveries		0.7	0.7
Effect of exchange rates		(0.1)	(0.1)
Ending balance	\$ 26.4	\$ 38.5	\$ 64.9

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	For the six months ended June 30, 2014		
	Commercial	Residential (in millions)	Total
Beginning balance	\$ 28.7	\$ 41.1	\$ 69.8
Provision	(2.0)	0.8	(1.2)
Charge-offs	(0.3)	(5.7)	(6.0)
Recoveries		2.4	2.4
Effect of exchange rates		(0.1)	(0.1)
Ending balance	\$ 26.4	\$ 38.5	\$ 64.9
Allowance ending balance by basis of impairment method:			
Individually evaluated for impairment	\$ 2.4	\$ 9.2	\$ 11.6
Collectively evaluated for impairment	24.0	29.3	53.3
Allowance ending balance	\$ 26.4	\$ 38.5	\$ 64.9
Loan balance by basis of impairment method:			
Individually evaluated for impairment	\$ 4.4	\$ 30.4	\$ 34.8
Collectively evaluated for impairment	10,378.5	1,243.7	11,622.2
Loan ending balance	\$ 10,382.9	\$ 1,274.1	\$ 11,657.0

	For the three months ended June 30, 2013		
	Commercial	Residential (in millions)	Total
Beginning balance	\$ 41.8	\$ 47.7	\$ 89.5
Provision	6.5	4.3	10.8
Charge-offs	(1.2)	(5.4)	(6.6)
Recoveries	0.6	0.7	1.3
Effect of exchange rates		(0.1)	(0.1)
Ending balance	\$ 47.7	\$ 47.2	\$ 94.9

	For the six months ended June 30, 2013		
	Commercial	Residential (in millions)	Total
Beginning balance	\$ 51.8	\$ 45.6	\$ 97.4
Provision	6.0	11.3	17.3
Charge-offs	(10.7)	(11.3)	(22.0)
Recoveries	0.6	1.7	2.3
Effect of exchange rates		(0.1)	(0.1)
Ending balance	\$ 47.7	\$ 47.2	\$ 94.9
Allowance ending balance by basis of impairment method:			
Individually evaluated for impairment	\$ 10.3	\$ 10.7	\$ 21.0
Collectively evaluated for impairment	37.4	36.5	73.9
Allowance ending balance	\$ 47.7	\$ 47.2	\$ 94.9
Loan balance by basis of impairment method:			
Individually evaluated for impairment	\$ 28.6	\$ 36.8	\$ 65.4
Collectively evaluated for impairment	10,890.1	1,261.1	12,151.2
Loan ending balance	\$ 10,918.7	\$ 1,297.9	\$ 12,216.6

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 troubled debt restructuring (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, and the

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

average recorded investment and interest income recognized during the time the loans were impaired were as follows:

	Recorded investment	June 30, 2014 Unpaid principal balance (in millions)		Related allowance
With no related allowance recorded:				
Commercial-brick and mortar	\$ 0.9	\$	2.2	\$
Residential-first liens	4.2		4.2	
With an allowance recorded:				
Commercial-brick and mortar	4.4		4.4	2.4
Residential-home equity	18.4		19.0	8.3
Residential-first liens	7.8		7.8	0.9
Total:				
Commercial	\$ 5.3	\$	6.6	\$ 2.4
Residential	\$ 30.4	\$	31.0	\$ 9.2

	Recorded investment	December 31, 2013 Unpaid principal balance (in millions)		Related allowance
With no related allowance recorded:				
Commercial-brick and mortar	\$ 21.5	\$	32.7	\$
Residential-first liens	4.6		4.6	
With an allowance recorded:				
Commercial-brick and mortar	4.4		4.4	2.4
Residential-home equity	19.5		19.7	9.2
Residential-first liens	8.9		7.8	1.0
Total:				
Commercial	\$ 25.9	\$	37.1	\$ 2.4
Residential	\$ 33.0	\$	32.1	\$ 10.2

	For the three months ended June 30, 2014		For the six months ended June 30, 2014	
	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized
	(in millions)			
With no related allowance recorded:				
Commercial-brick and mortar	\$ 0.9	\$ 0.1	\$ 11.2	\$ 0.1
Residential-first liens	4.4		4.4	
With an allowance recorded:				
Commercial-brick and mortar	4.4		4.4	0.1

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

Residential-home equity		18.6		0.1		18.9		0.3
Residential-first liens		8.2		0.1		8.4		0.1
Total:								
Commercial	\$	5.3	\$	0.1	\$	15.6	\$	0.2
Residential	\$	31.2	\$	0.2	\$	31.7	\$	0.4

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	For the three months ended June 30, 2013		For the six months ended June 30, 2013	
	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized
	(in millions)			
With no related allowance recorded:				
Commercial-brick and mortar	\$ 27.5	\$	\$ 13.1	\$ 0.1
Residential-first liens	5.8		8.1	
With an allowance recorded:				
Commercial-brick and mortar	17.3	0.1	15.3	0.1
Residential-home equity	20.5	0.2	20.7	0.4
Residential-first liens	9.6	0.1	9.4	0.1
Total:				
Commercial	\$ 44.8	\$ 0.1	\$ 28.4	\$ 0.2
Residential	\$ 35.9	\$ 0.3	\$ 38.2	\$ 0.5

Mortgage Loan Modifications

Our commercial and residential mortgage loan portfolios include loans that have been modified. We assess loan modifications on a case-by-case basis to evaluate whether a TDR has occurred. The commercial mortgage loan TDRs were modified to delay or reduce principal payments and to increase, reduce or delay interest payments. For these TDR assessments, we have determined the loan rates are now considered below market based on current circumstances. The commercial mortgage loan modifications resulted in delayed cash receipts and a decrease in interest income. The residential mortgage loan TDRs include modifications of interest-only payment periods, delays in principal balloon payments, and interest rate reductions. Residential mortgage loan modifications resulted in delayed or decreased cash receipts and a decrease in interest income.

The following table includes information about outstanding loans that were modified and met the criteria of a TDR during the periods indicated. In addition, the table includes information for loans that were modified and met the criteria of a TDR within the past twelve months that were in payment default during the periods indicated:

	Number of contracts	For the three months ended June 30, 2014	
		TDRs Recorded investment (in millions)	TDRs in payment default Number of contracts Recorded investment (in millions)
Commercial-brick and mortar	1	\$ 0.7	\$
Residential-home equity	26	1.0	2
Residential-first liens	1	0.1	
Total	28	\$ 1.8	\$ 2

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

	For the three months ended June 30, 2013			
	Number of contracts	TDRs Recorded investment (in millions)	Number of contracts	TDRs in payment default Recorded investment (in millions)
Commercial-brick and mortar	1	\$ 0.2		\$
Residential-home equity	21	0.8	1	
Residential-first liens	1	0.2	2	0.7
Total	23	\$ 1.2	3	\$ 0.7

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	Number of contracts	TDRs	For the six months ended June 30, 2014	
			Recorded investment (in millions)	TDRs in payment default
			Number of contracts	Recorded investment (in millions)
Commercial-brick and mortar	2	\$	5.1	\$
Residential-home equity	39		1.4	2
Residential-first liens	1		0.1	
Total	42	\$	6.6	2 \$

	Number of contracts	TDRs	For the six months ended June 30, 2013	
			Recorded investment (in millions)	TDRs in payment default
			Number of contracts	Recorded investment (in millions)
Commercial-brick and mortar	2	\$	0.9	\$
Residential-home equity	53		2.8	13
Residential-first liens	3		0.6	2 0.7
Total	58	\$	4.3	15 \$ 0.7

Commercial mortgage loans that have been designated as a TDR have been previously reserved in the mortgage loan valuation allowance to the estimated fair value of the underlying collateral reduced by the cost to sell.

Residential mortgage loans that have been designated as a TDR are specifically reserved for in the mortgage loan valuation allowance if losses result from the modification. Residential mortgage loans that have defaulted or have been discharged through bankruptcy are reduced to the expected collectible amount.

Securities Posted as Collateral

We posted \$1,305.2 million in fixed maturities, available-for-sale securities at June 30, 2014, to satisfy collateral requirements primarily associated with a reinsurance arrangement, our derivative credit support annex (collateral) agreements, Futures Commission Merchant (FCM) agreements, a lending arrangement and our obligation under funding agreements with the Federal Home Loan Bank of Des Moines (FHLB Des Moines). In addition, we posted \$2,210.9 million in commercial mortgage loans and home equity mortgages as of June 30, 2014, to satisfy collateral requirements associated with our obligation under funding agreements with the FHLB Des Moines. Since we did not relinquish ownership rights on these instruments, they are reported as fixed maturities, available-for-sale and mortgage loans, respectively, on our consolidated statements of financial position.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Balance Sheet Offsetting

We have financial instruments that are subject to master netting agreements or similar agreements. Financial assets subject to master netting agreements or similar agreements were as follows:

	Gross amount of recognized assets (1)	Gross amounts not offset in the Statement of Financial Position			
		Financial instruments (2)	Collateral received	(in millions)	Net amount
June 30, 2014					
Derivative assets	\$ 604.0	\$ (487.9)	\$ (100.0)		\$ 16.1
Reverse repurchase agreements	48.0		(48.0)		
Total	\$ 652.0	\$ (487.9)	\$ (148.0)		\$ 16.1
December 31, 2013					
Derivative assets	\$ 664.9	\$ (581.5)	\$ (82.1)		\$ 1.3
Reverse repurchase agreements	51.8		(51.8)		
Total	\$ 716.7	\$ (581.5)	\$ (133.9)		\$ 1.3

(1) The gross amount of recognized derivative and reverse repurchase agreement assets are reported with other investments and cash and cash equivalents on the consolidated statements of financial position. The above excludes \$0.2 million and \$0.2 million of derivative assets as of June 30, 2014 and December 31, 2013, respectively, that are not subject to master netting agreements or similar agreements. The gross amounts of derivative and reverse repurchase agreement assets are not netted against offsetting liabilities for presentation on the consolidated statements of financial position.

(2) Represents amount of offsetting derivative liabilities that are subject to an enforceable master netting agreement or similar agreement that are not netted against the gross derivative assets for presentation on the consolidated statements of financial position.

Financial liabilities subject to master netting agreements or similar agreements were as follows:

	Gross amount of recognized liabilities (1)	Statement of Financial Position			
		Financial instruments (2)	Collateral pledged	(in millions)	Net amount
June 30, 2014					
Derivative liabilities	\$ 860.7	\$ (487.9)	\$ (305.8)		\$ 67.0
December 31, 2013					
Derivative liabilities	\$ 1,022.0	\$ (581.5)	\$ (362.1)		\$ 78.4

- (1) The gross amount of recognized derivative liabilities are reported with other liabilities on the consolidated statements of financial position. The above excludes \$284.7 million and \$226.7 million of derivative liabilities as of June 30, 2014 and December 31, 2013, respectively, which are primarily embedded derivatives that are not subject to master netting agreements or similar agreements. The gross amounts of derivative liabilities are not netted against offsetting assets for presentation on the consolidated statements of financial position.
- (2) Represents amount of offsetting derivative assets that are subject to an enforceable master netting agreement or similar agreement that are not netted against the gross derivative liabilities for presentation on the consolidated statements of financial position.

The financial instruments that are subject to master netting agreements or similar agreements include right of setoff provisions. Derivative instruments include provisions to setoff positions covered under the agreements with the same counterparties and provisions to setoff positions outside of the agreements with the same counterparties in the event of default by one of the parties. Derivative instruments also include collateral provisions. Collateral received and pledged is generally settled daily with each counterparty. See Note 4, Derivative Financial Instruments, for further details.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Repurchase and reverse repurchase agreements include provisions to setoff other repurchase and reverse repurchase balances with the same counterparty. Repurchase and reverse repurchase agreements also include collateral provisions with the counterparties. For reverse repurchase agreements we require the counterparties to pledge collateral with a value greater than the amount of cash transferred. We have the right but do not sell or repledge collateral received in reverse repurchase agreements. Repurchase agreements are structured as secured borrowings for all counterparties. We pledge fixed maturities available-for-sale, which the counterparties have the right to sell or repledge. Interest incurred on repurchase agreements is reported as part of operating expense on the consolidated statements of operations. Net proceeds related to repurchase agreements are reported as a component of financing activities on the consolidated statements of cash flows. We did not have any outstanding repurchase agreements as of June 30, 2014 and December 31, 2013.

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 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.

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 any party. Cash is paid or received based on the terms of the swap. 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 options, including 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 use interest rate collars to manage interest rate risk related to guaranteed minimum interest rate liabilities in our individual annuities contracts and lapse risk associated with higher interest rates.

A swaption is an option to enter into an interest rate swap at a future date. We purchase swaptions to offset or modify 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.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Foreign Exchange Contracts

Foreign currency risk is the risk 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 the financial results of our international operations, including acquisition and divestiture activity. We use various derivatives to manage our exposure to fluctuations in foreign currency exchange rates.

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 or receive 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 and to hedge the currency risk associated with a business combination. 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 2014 or 2013 to hedge our net investment in foreign operations.

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 purchase equity call spreads to hedge the equity participation rates promised to contractholders in conjunction with our fixed deferred annuity and universal life 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, we also buy a quality cash bond to match against the credit default swap, thereby entering into a synthetic transaction replicating a cash security. 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.

Total return swaps are contracts in which we agree with other parties to exchange, at specified intervals, an amount determined by the difference between the previous price and the current price of a reference asset based upon an agreed upon notional principal amount plus an additional amount determined by the financing spread. We currently use futures traded on an exchange (exchange-traded) and total return swaps referencing equity indices to hedge our portfolio from potential credit losses related to systemic events.

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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

characteristics that are not clearly or 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 have investment-type insurance contracts in which the return is tied to a leveraged inflation index. In addition, we had an investment-type insurance contract in which the return was tied to an external equity index. We economically hedge the risk associated with these investment-type insurance contracts.

We offer group annuity contracts that have guaranteed separate accounts as an investment option. We also offer funds with embedded fixed-rate guarantees as investment options 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 and universal life contracts that credit interest based on changes in an external equity index. We also have certain variable annuity products with a GMWB rider, which allows the customer to make withdrawals of a specified annual amount, either for a fixed number of years or for the lifetime of the customer, even if the account value is fully exhausted. Declines in the equity markets may increase our exposure to benefits under contracts with the GMWB. We economically hedge the exposure in these contracts, as previously explained.

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. 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.

Derivatives may be exchange-traded or they may be privately negotiated contracts, which are usually referred to as over-the-counter (OTC) derivatives. Certain of our OTC derivatives are cleared and settled through central clearing counterparties (OTC cleared), while others are bilateral contracts between two counterparties (bilateral OTC). Our derivative transactions are generally documented under International Swaps

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

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 \$342.7 million and \$393.1 million in cash and securities under collateral arrangements as of June 30, 2014 and December 31, 2013, respectively, to satisfy collateral requirements associated with our derivative credit support agreements and FCM agreements. These amounts include initial margin requirements.

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 ratings 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 June 30, 2014 and December 31, 2013, was \$791.4 million and \$1,042.9 million, respectively. Cleared derivatives have contingent features that require us to post excess margin as required by the FCM. The terms surrounding excess margin vary by FCM agreement. With respect to derivatives containing collateral triggers, we posted collateral and initial margin of \$342.7 million and \$393.1 million as of June 30, 2014 and December 31, 2013, respectively, in the normal course of business, which reflects netting under derivative agreements. If the credit-risk-related contingent features underlying these agreements were triggered on June 30, 2014, we would be required to post an additional \$69.8 million of collateral to our counterparties.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

As of June 30, 2014 and December 31, 2013, we had received \$51.5 million and \$32.5 million, respectively, of cash collateral associated with our derivative credit support annex agreements and FCM agreements, for which we recorded a corresponding liability reflecting our obligation to return the collateral.

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:

	June 30, 2014	December 31, 2013
	(in millions)	
Notional amounts of derivative instruments		
Interest rate contracts:		
Interest rate swaps	\$ 19,204.2	\$ 20,570.8
Interest rate options	4,100.0	4,100.0
Swaptions	260.0	325.0
Interest rate futures	105.0	92.5
Foreign exchange contracts:		
Currency swaps	2,048.0	2,367.5
Currency forwards	261.6	247.4
Equity contracts:		
Equity options	2,740.4	2,010.4
Equity futures	371.6	273.3
Credit contracts:		
Credit default swaps	1,150.6	1,153.2
Total return swaps	90.0	90.0
Futures	9.5	9.1
Other contracts:		
Embedded derivative financial instruments	8,796.0	7,601.1
Total notional amounts at end of period	\$ 39,136.9	\$ 38,840.3
Credit exposure of derivative instruments		
Interest rate contracts:		
Interest rate swaps	\$ 431.1	\$ 435.5
Interest rate options	31.7	42.5
Swaptions	0.2	1.0
Foreign exchange contracts:		
Currency swaps	137.7	200.9
Currency forwards	0.2	0.6
Equity contracts:		
Equity options	17.1	30.0
Credit contracts:		
Credit default swaps	11.5	9.5
Total return swaps	0.1	0.1

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

Total gross credit exposure		629.5		720.1
Less: collateral received		100.0		115.9
Net credit exposure	\$	529.5	\$	604.2

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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

	Derivative assets (1)		Derivative liabilities (2)	
	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
(in millions)				
Derivatives designated as hedging instruments				
Interest rate contracts	\$ 2.7	\$ 0.1	\$ 229.0	\$ 285.4
Foreign exchange contracts	96.5	121.6	44.0	51.2
Total derivatives designated as hedging instruments	\$ 99.2	\$ 121.7	\$ 273.0	\$ 336.6
Derivatives not designated as hedging instruments				
Interest rate contracts	\$ 429.5	\$ 452.2	\$ 358.3	\$ 489.6
Foreign exchange contracts	46.9	51.6	22.3	17.9
Equity contracts	17.1	30.0	187.7	145.0
Credit contracts	11.5	9.6	22.5	35.5
Other contracts			281.6	224.1
Total derivatives not designated as hedging instruments	505.0	543.4	872.4	912.1
Total derivative instruments	\$ 604.2	\$ 665.1	\$ 1,145.4	\$ 1,248.7

(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 \$37.6 million and \$6.9 million as of June 30, 2014 and December 31, 2013, 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). 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.

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

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 \$44.9 million as of June 30, 2014 and \$44.9 million as of December 31, 2013. These purchased credit derivative transactions had a net asset (liability) fair value of \$(0.5) million as of June 30, 2014 and \$(0.5) million as of December 31, 2013. In certain circumstances, our potential loss could also be reduced by any amount recovered in the default proceedings of the underlying credit name.

We purchased an investment structure with embedded credit features that is 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 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
June 30, 2014
(Unaudited)

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.

	June 30, 2014			
	Notional amount	Fair value (in millions)	Maximum future payments	Weighted average expected life (in years)
Single name credit default swaps				
Corporate debt				
AAA	\$ 20.0	\$ 0.6	\$ 20.0	4.5
AA	79.0	1.5	79.0	3.6
A	269.5	4.7	269.5	3.6
BBB	290.0	3.2	290.0	3.9
BB	15.0	(0.3)	15.0	8.0
Total single name credit default swaps	673.5	9.7	673.5	3.9
Basket and index credit default swaps				
Corporate debt				
Near default (1)	110.4	(12.3)	110.4	2.7
Government/municipalities				
AA	30.0	(2.4)	30.0	3.2
Structured finance				
BBB	25.0	(0.2)	25.0	3.0
Total basket and index credit default swaps	165.4	(14.9)	165.4	2.9
Total credit default swap protection sold	\$ 838.9	\$ (5.2)	\$ 838.9	3.7

	December 31, 2013			
	Notional amount	Fair value (in millions)	Maximum future payments	Weighted average expected life (in years)
Single name credit default swaps				
Corporate debt				
AAA	\$ 10.0	\$ 0.3	\$ 10.0	4.7
AA	84.0	1.8	84.0	4.0
A	294.5	4.2	294.5	4.0
BBB	265.0	(1.2)	265.0	3.9
Total single name credit default swaps	653.5	5.1	653.5	4.0
Basket and index credit default swaps				
Corporate debt				
Near default (1)	110.4	(19.9)	110.4	3.2

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

Government/municipalities

AA	30.0	(3.5)	30.0	3.7
Structured finance				
BBB	25.0	(0.9)	25.0	3.5
Total basket and index credit default swaps	165.4	(24.3)	165.4	3.4
Total credit default swap protection sold	\$ 818.9	\$ (19.2)	\$ 818.9	3.9

(1) Includes \$88.0 million notional of derivatives in consolidated collateralized private investment vehicle VIEs where the credit risk is borne by third-party investors.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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.

	June 30, 2014		Weighted average expected life (in years)
	Amortized cost	Carrying value (in millions)	
Corporate debt			
A	\$ 23.8	\$ 23.8	2.5
Total corporate debt	23.8	23.8	2.5
Structured finance			
A	6.3	6.3	16.1
BB	5.8	5.8	3.0
B	4.3	4.3	2.8
CCC	9.1	9.1	5.4
Total structured finance	25.5	25.5	7.1
Total fixed maturities with credit derivatives	\$ 49.3	\$ 49.3	4.9

	December 31, 2013		Weighted average expected life (in years)
	Amortized cost	Carrying value (in millions)	
Corporate debt			
BBB	\$ 23.4	\$ 23.4	3.0
Total corporate debt	23.4	23.4	3.0
Structured finance			
A	18.1	16.7	4.8
BB	5.5	5.5	3.3
B	4.1	4.1	3.1
CCC	23.5	23.5	4.8
Total structured finance	51.2	49.8	4.5
Total fixed maturities with credit derivatives	\$ 74.6	\$ 73.2	4.0

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.

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.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 June 30, (1)		Hedged items in fair value hedging relationships	Amount of gain (loss) recognized in net income on related hedged item for the three months ended June 30, (1)	
	2014	2013		2014	2013
	(in millions)			(in millions)	
Interest rate contracts	\$ 1.8	\$ 65.9	Fixed maturities, available-for-sale	\$ (2.7)	\$ (62.7)
Interest rate contracts	2.0		Investment-type insurance contracts	(1.9)	
Foreign exchange contracts	0.5		Fixed maturities, available-for-sale	(0.4)	0.1
Foreign exchange contracts		(10.0)	Investment-type insurance contracts		9.9
Total	\$ 4.3	\$ 55.9	Total	\$ (5.0)	\$ (52.7)

Derivatives in fair value hedging relationships	Amount of gain (loss) recognized in net income on derivatives for the six months ended June 30, (1)		Hedged items in fair value hedging relationships	Amount of gain (loss) recognized in net income on related hedged item for the six months ended June 30, (1)	
	2014	2013		2014	2013
	(in millions)			(in millions)	
Interest rate contracts	\$ 8.7	\$ 96.3	Fixed maturities, available-for-sale	\$ (10.1)	\$ (91.3)
Interest rate contracts	2.6		Investment-type insurance contracts	(2.5)	
Foreign exchange contracts	0.8	1.3	Fixed maturities, available-for-sale	(0.7)	(1.2)
Foreign exchange contracts	0.2	(74.1)	Investment-type insurance contracts	(0.2)	73.6
Total	\$ 12.3	\$ 23.5	Total	\$ (13.5)	\$ (18.9)

(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.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 June 30,		Amount of gain (loss) for the six months ended June 30,	
	2014	2013	2014	2013
	(in millions)			
Fixed maturities, available-for-sale (1)	\$ (23.1)	\$ (29.7)	\$ (49.3)	\$ (61.2)
Investment-type insurance contracts (2)	0.9	10.0	2.4	19.3

-
- (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.

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 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 6.0 years. At June 30, 2014, we had \$68.7 million of net 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 AOCI into net income. We reclassified \$0.0 million and \$0.2 million from AOCI into net realized capital gains (losses) as a result of the determination that hedged cash flows were probable of not occurring during the six months ended June 30, 2014 and 2013, respectively.

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

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 June 30,		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 June 30,	
		2014	2013		2014	2013
		(in millions)		(in millions)		
Interest rate contracts	Fixed maturities, available-for-sale	\$ (1.7)	\$ (17.5)	Net investment income	\$ 3.4	\$ 2.9
Interest rate contracts	Investment-type insurance contracts	1.5	0.1	Benefits, claims and settlement expenses		
Interest rate contracts	Debt			Operating expense	(1.8)	(1.6)
Foreign exchange contracts	Fixed maturities, available-for-sale	(4.2)	0.6	Net realized capital losses		(1.5)
Foreign exchange contracts	Investment-type insurance contract	3.4	3.0	Benefits, claims and settlement expenses		
Total		\$ (1.0)	\$ (13.8)	Total	\$ 1.6	\$ (0.2)

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Derivatives in cash flow hedging relationships	Related hedged item	Amount of gain (loss) recognized in AOCI on derivatives (effective portion) for the six months ended June 30,		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 six months ended June 30,		
		2014	2013		2014	2013	
		(in millions)				(in millions)	
Interest rate contracts	Fixed maturities, available-for-sale	\$ 2.0	\$ (41.2)	Net investment income	\$ 6.6	\$ 5.6	
Interest rate contracts	Investment-type insurance contracts	2.4	1.1	Benefits, claims and settlement expenses			
Interest rate contracts	Debt			Operating expense	(3.6)	(3.2)	
Foreign exchange contracts	Fixed maturities, available-for-sale	(0.2)	41.6	Net realized capital losses	(11.1)	(2.1)	
Foreign exchange contracts	Investment-type insurance contract	8.5	(0.6)	Benefits, claims and settlement expenses			
Total		\$ 12.7	\$ 0.9	Total	\$ (8.1)	\$ 0.3	

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 June 30,		Amount of gain (loss) for the six months ended June 30,	
	2014	2013	2014	2013
(in millions)				
Fixed maturities, available-for-sale (1)	\$ 1.3	\$ 1.9	\$ 2.8	\$ 4.3
Investment-type insurance contracts (2)	(2.9)	(2.6)	(5.8)	(5.5)

(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.

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 (loss) resulting from the ineffective portion of foreign currency contracts in cash flow hedging relationships was \$(0.1) million and \$0.1 million for the three months ended June 30, 2014 and 2013, respectively. The net gain (loss) resulting from the ineffective portion of foreign currency contracts in cash flow hedging relationships was \$(0.1) million and \$0.4 million for the six months ended June 30, 2014 and 2013, respectively.

We expect to reclassify net gains of \$1.8 million from AOCI into net income in the next 12 months, which includes both net deferred gains on discontinued hedges and net 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.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

The following table shows the effect of derivatives not designated as hedging instruments, including fair 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 June 30,		Amount of gain (loss) recognized in net income on derivatives for the six months ended June 30,	
	2014	2013	2014	2013
	(in millions)			
Interest rate contracts	\$ 33.1	\$ (62.5)	\$ 96.4	\$ (92.1)
Foreign exchange contracts	0.4	(16.1)	(12.9)	(11.8)
Equity contracts	(12.6)	(16.9)	(37.6)	(71.5)
Credit contracts	15.8	7.3	10.9	22.4
Other contracts	(19.8)	42.3	(46.5)	99.5
Total	\$ 16.9	\$ (45.9)	\$ 10.3	\$ (53.5)

5. Income Taxes

The effective income tax rate for the three months ended June 30, 2014, 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, the presentation of taxes on our share of earnings generated from equity method investments reflected in net investment income and lower tax rates of foreign jurisdictions.

The effective income tax rate for the three months ended June 30, 2013, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received, a Chilean tax benefit resulting from a foreign currency loss on a U.S. denominated loan and the presentation of taxes on our share of earnings generated from equity method investments reflected in net investment income.

The effective income tax rate for the six months ended June 30, 2014, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received, the presentation of taxes on our share of earnings generated from equity method investments reflected in net investment income and tax credits.

The effective income tax rate for the six months ended June 30, 2013, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received, the presentation of taxes on our share of earnings generated from equity method investments reflected in net investment income and a Chilean tax benefit resulting from a foreign currency loss on a U.S. denominated loan.

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

We are a U.S. shareholder in various foreign entities classified as controlled foreign corporations (CFCs) for U.S. tax purposes. U.S. shareholders of CFCs are generally required to take into account as gross income in the U.S. certain passive income earned by the CFCs (Subpart F income) even if the income is not currently distributed. Temporary exceptions (the active financing and look through exceptions) were applicable for tax years beginning before January 1, 2014 to avoid the current recognition of Subpart F income derived in either the active conduct of a banking, financing, insurance or similar business or for certain payments between related corporations in different foreign jurisdictions. The U.S. Congress and the President have yet to enact extenders legislation as of June 30, 2014. Therefore, current tax expense has increased by an immaterial amount associated with the U.S. recognition of Subpart F income from our foreign operations. We will reverse any tax expense subject to the active financing and look through exceptions during the 2014 quarter extenders legislation is enacted, assuming the legislation is retroactive to January 1, 2014.

The U.S. Court of Federal Claims issued a summary judgment determination in the case of Principal Life Insurance Company and Subsidiaries (Principal Life) v. the United States on May 9, 2014. The court ruled against Principal Life s timing of recognition of gains and losses associated with the purchase and sale of principal-only certificates. The ruling caused a re-evaluation of our uncertain tax positions, which resulted in a \$47.5 million reduction in net income in the second quarter of 2014. We do not believe there is a reasonable possibility the total amount of uncertain tax benefits will significantly increase or decrease in the next twelve months.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Unrecognized Tax Benefits

A summary of the changes in unrecognized tax benefits follows:

	For the six months ended June 30, 2014		For the year ended December 31, 2013	
	(in millions)			
Balance at beginning of period	\$	108.9	\$	119.5
Additions based on tax positions related to the current year		1.5		10.5
Additions for tax positions of prior years		61.4		10.9
Reductions for tax positions related to the current year				(3.3)
Reductions for tax positions of prior years				(28.7)
Balance at end of period (1)	\$	171.8	\$	108.9

(1) Of this amount, \$58.3 million, if recognized, would reduce the 2014 effective income tax rate. We recognize interest and penalties related to uncertain tax positions in operating expenses.

As of June 30, 2014 and December 31, 2013, we had recognized \$99.8 million and \$37.0 million of accumulated pre-tax interest and penalties related to unrecognized tax benefits, respectively.

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

	Pension benefits			Other postretirement benefits		
	For the three months ended June 30,			For the three months ended June 30,		
	2014	2013		2014	2013	
	(in millions)					
Service cost	\$	13.5	\$	14.3	\$	0.3
Interest cost		29.3		25.9		1.6
Expected return on plan assets		(33.0)		(31.9)		(8.2)
Amortization of prior service benefit		(1.2)		(2.1)		(5.1)
						(6.5)

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

Recognized net actuarial (gain) loss		12.5		29.6		(0.7)		0.3
Net periodic benefit cost (income)	\$	21.1	\$	35.8	\$	(12.1)	\$	(11.7)

	Pension benefits			Other postretirement benefits				
	For the six months ended June 30,			For the six months ended June 30,				
	2014		2013	2014		2013		
	(in millions)							
Service cost	\$	27.0	\$	28.6	\$	0.7	\$	0.6
Interest cost		58.6		51.8		3.3		2.8
Expected return on plan assets		(66.0)		(63.8)		(16.3)		(14.4)
Amortization of prior service benefit		(2.4)		(4.2)		(10.2)		(13.0)
Recognized net actuarial (gain) loss		25.3		59.1		(1.7)		0.6
Net periodic benefit cost (income)	\$	42.5	\$	71.5	\$	(24.2)	\$	(23.4)

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 2014 will be zero so we will not be required to fund our qualified pension plan during 2014. However, it is possible that we may fund the qualified and

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

nonqualified pension plans in 2014 for a combined total of \$125.0 million to \$175.0 million. During the three and six months ended June 30, 2014, we contributed \$17.2 million and \$57.5 million to these plans, respectively.

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; individual life insurance, specialty benefits insurance and our investment activities. Some of the lawsuits may be class actions, or purport to be, and some may include claims for unspecified or substantial punitive and treble damages.

We may discuss such litigation in one of three ways. We accrue a charge to income and disclose legal matters for which the chance of loss is probable and for which the amount of loss can be reasonably estimated. We may disclose contingencies for which the chance of loss is reasonably possible and provide an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made. Finally, we may voluntarily disclose loss contingencies for which the chance of loss is remote in order to provide information concerning matters that potentially expose us to possible losses.

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 March 18, 2014, McCaffree Financial Corp. Employee Retirement Program (McCaffree) filed a putative class action lawsuit in the United States District Court for the Southern District of Iowa against Principal Life. The complaint alleged, among other things, breach of duty of loyalty, breach of duty of prudence and prohibited transactions under ERISA. McCaffree seeks a nationwide class action on behalf of all participants and beneficiaries of defined contribution retirement plans that invested in any Principal Separate Account in the last six years. McCaffree seeks disgorgement of all fees it alleges Principal Life improperly retained in addition to other general claims for relief. Principal Life has filed a motion to dismiss the case and is aggressively defending the case.

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

On August 29, 2013, American Chemicals & Equipment, Inc. 401(k) Retirement Plan (ACE) filed a lawsuit in the United States District Court for the Northern District of Alabama against Principal Management Corporation and Principal Global Investors, LLC (the ACE Defendants). The lawsuit alleges the ACE Defendants breached their fiduciary duty under Section 36(b) of the Investment Company Act by charging excessive fees on certain of the LifeTime series target date funds. On January 24, 2014, the court granted the motion filed by the ACE Defendants to transfer the case to the Southern District of Iowa. The ACE Defendants have filed a motion to dismiss the case and 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; Principal Management Corporation; 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. 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. Plaintiffs request for permission to appeal the denial of class certification was denied by the U.S. Eighth Circuit Court of Appeals on December 31, 2013. The Cruise/Mullaney Defendants are aggressively defending the lawsuit.

In 2008, Principal Life received approximately \$440.0 million in connection with the termination of certain structured transactions and the resulting prepayment of Principal Life s investment in those transactions. The transactions involved Lehman Brothers Special Financing Inc. and Lehman Brothers Holdings Inc. (collectively, Lehman) in various capacities. Subsequent to Lehman s 2008 bankruptcy filing, its bankruptcy estate initiated several lawsuits seeking to recover from numerous sources significant amounts to which it claims entitlement under various theories. The estate is attempting to recover from Principal Life an amount, including interest, of approximately \$500.0 million. We are one of numerous defendants to this action, which has been stayed by the bankruptcy court. We believe that we have meritorious defenses to Lehman s claims and intend to aggressively defend against them once the stay is lifted and we are allowed to do so.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

While the outcome of any pending or future litigation or regulatory matter cannot be predicted, management does not believe that any such matter will have a material adverse effect on our business or financial position. As of June 30, 2014, there were no estimated losses accrued related to the legal matters discussed above because we believe the loss from these matters is not probable and cannot be reasonably estimated.

We believe all of the litigation contingencies discussed above involve a chance of loss that is either remote or reasonably possible. Unless otherwise noted, all of these matters involve unspecified claim amounts, in which the respective plaintiffs seek an indeterminate amount of damages. To the extent such matters present a reasonably possible chance of loss, we are generally not able to estimate the possible loss or range of loss associated therewith.

The outcome of such matters is always uncertain, and unforeseen results can occur. It is possible that such outcomes could require us to pay damages or make other expenditures or establish accruals in amounts that we could not estimate at June 30, 2014.

Guarantees and Indemnifications

In the normal course of business, we have provided guarantees to third parties primarily related to former subsidiaries and joint ventures. These agreements generally expire through 2019. The maximum exposure under these agreements as of June 30, 2014, was approximately \$284.0 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 manage mandatory privatized social security funds in Chile. By regulation, we have a required minimum guarantee on the funds relative return. Because the guarantee has no limitation with respect to duration or amount, the maximum exposure of the guarantee in the future is indeterminable.

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.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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

	Series A preferred stock	Series B preferred stock (in millions)	Common stock
Outstanding shares at January 1, 2013	3.0	10.0	293.8
Shares issued			3.0
Treasury stock acquired			(2.9)
Outstanding shares at June 30, 2013	3.0	10.0	293.9
Outstanding shares at January 1, 2014	3.0	10.0	295.2
Shares issued			1.9
Treasury stock acquired			(3.3)
Outstanding shares at June 30, 2014	3.0	10.0	293.8

Our Board of Directors has authorized various repurchase programs under which we are allowed to purchase shares of our outstanding common stock. Shares repurchased under these programs are accounted for as treasury stock, carried at cost and reflected as a reduction to stockholders equity.

In May 2012, our Board of Directors authorized a share repurchase program of up to \$200.0 million of our outstanding common stock. We completed this program in February 2013. In February 2013, our Board of Directors authorized a share repurchase program of up to \$150.0 million of our outstanding common stock, which was completed in March 2014. In February 2014, our Board of Directors authorized a share repurchase program of up to \$200.0 million of our outstanding common stock.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Other Comprehensive Income (Loss)

	For the three months ended June 30, 2014			For the six months ended June 30, 2014		
	Pre-Tax	Tax	After-Tax	Pre-Tax	Tax	After-Tax
	(in millions)					
Net unrealized gains on available-for-sale securities during the period	\$ 651.2	\$ (221.2)	\$ 430.0	\$ 1,311.7	\$ (444.5)	\$ 867.2
Reclassification adjustment for gains included in net income (1)	(38.7)	12.6	(26.1)	(61.7)	20.2	(41.5)
Adjustments for assumed changes in amortization patterns	(44.9)	15.7	(29.2)	(99.2)	34.7	(64.5)
Adjustments for assumed changes in policyholder liabilities	(290.0)	93.6	(196.4)	(584.5)	193.8	(390.7)
Net unrealized gains on available-for-sale securities	277.6	(99.3)	178.3	566.3	(195.8)	370.5
Noncredit component of impairment losses on fixed maturities, available-for-sale during the period	37.8	(13.8)	24.0	67.9	(24.3)	43.6
Adjustments for assumed changes in amortization patterns	(5.2)	1.8	(3.4)	(8.4)	3.1	(5.3)
Adjustments for assumed changes in policyholder liabilities	(0.4)	0.2	(0.2)	(0.6)	0.2	(0.4)
Noncredit component of impairment losses on fixed maturities, available-for-sale (2)	32.2	(11.8)	20.4	58.9	(21.0)	37.9
Net unrealized gains on derivative instruments during the period	9.6	(3.4)	6.2	19.3	(6.8)	12.5
Reclassification adjustment for (gains) losses included in net income (3)	(1.6)	0.5	(1.1)	8.1	(3.0)	5.1
Adjustments for assumed changes in amortization patterns	(0.3)	0.2	(0.1)	(0.5)	0.2	(0.3)
Adjustments for assumed changes in policyholder liabilities	(1.2)	0.3	(0.9)	(6.5)	2.3	(4.2)
Net unrealized gains on derivative instruments	6.5	(2.4)	4.1	20.4	(7.3)	13.1
Foreign currency translation adjustment	34.5	(1.5)	33.0	(20.9)	8.3	(12.6)
Amortization of prior service cost and actuarial loss included in net periodic benefit cost (4)	5.5	(1.9)	3.6	11.0	(3.9)	7.1
Net unrecognized postretirement benefit obligation	5.5	(1.9)	3.6	11.0	(3.9)	7.1
Other comprehensive income	\$ 356.3	\$ (116.9)	\$ 239.4	\$ 635.7	\$ (219.7)	\$ 416.0

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	For the three months ended June 30, 2013			For the six months ended June 30, 2013		
	Pre-Tax	Tax	After-Tax	Pre-Tax	Tax	After-Tax
	(in millions)					
Net unrealized losses on available-for-sale securities during the period	\$ (1,405.2)	\$ 456.5	\$ (948.7)	\$ (1,537.5)	\$ 502.5	\$ (1,035.0)
Reclassification adjustment for losses included in net income (1)	24.3	(8.1)	16.2	58.4	(19.8)	38.6
Adjustments for assumed changes in amortization patterns	168.1	(58.8)	109.3	211.8	(74.1)	137.7
Adjustments for assumed changes in policyholder liabilities	543.5	(174.0)	369.5	451.6	(145.9)	305.7
Net unrealized losses on available-for-sale securities	(669.3)	215.6	(453.7)	(815.7)	262.7	(553.0)
Noncredit component of impairment losses on fixed maturities, available-for-sale during the period	2.1	(0.3)	1.8	(18.1)	6.8	(11.3)
Adjustments for assumed changes in amortization patterns	(1.1)	0.2	(0.9)	0.1		0.1
Adjustments for assumed changes in policyholder liabilities	(0.4)	0.2	(0.2)	1.0	(0.4)	0.6
Noncredit component of impairment losses on fixed maturities, available-for-sale (2)	0.6	0.1	0.7	(17.0)	6.4	(10.6)
Net unrealized gains (losses) on derivative instruments during the period	(18.6)	6.6	(12.0)	14.0	(4.2)	9.8
Reclassification adjustment for (gains) losses included in net income (3)	0.2	(0.1)	0.1	(0.3)		(0.3)
Adjustments for assumed changes in amortization patterns	5.4	(1.8)	3.6	6.4	(2.2)	4.2
Adjustments for assumed changes in policyholder liabilities	12.6	(4.6)	8.0	12.6	(4.6)	8.0
Net unrealized gains (losses) on derivative instruments	(0.4)	0.1	(0.3)	32.7	(11.0)	21.7
Foreign currency translation adjustment	(200.4)	10.0	(190.4)	(145.3)	9.3	(136.0)
Amortization of prior service cost and actuarial loss included in net periodic benefit cost (4)	21.3	(7.5)	13.8	42.5	(14.9)	27.6
Net unrecognized postretirement benefit obligation	21.3	(7.5)	13.8	42.5	(14.9)	27.6
Other comprehensive loss	\$ (848.2)	\$ 218.3	\$ (629.9)	\$ (902.8)	\$ 252.5	\$ (650.3)

-
- (1) Pre-tax reclassification adjustments relating to available-for-sale securities are reported in net realized capital gains (losses) on the consolidated statements of operations.
- (2) 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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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.

(3) See Note 4, Derivative Financial Instruments – Cash Flow Hedges, for further details.

(4) Pre-tax amortization of prior service cost and actuarial loss included in net periodic benefit cost, which is comprised of amortization of prior service cost (benefit) and recognized net actuarial (gain) loss, is reported in operating expenses on the consolidated statements of operations. See Note 6, Employee and Agent Benefits – Components of Net Periodic Benefit Cost, for further details.

Accumulated Other Comprehensive Income (Loss)

	Net unrealized gains on available-for-sale securities	Noncredit component of impairment losses on fixed maturities available-for-sale	Net unrealized gains (losses) on derivative instruments (in millions)	Foreign currency translation adjustment	Unrecognized postretirement benefit obligation	Accumulated other comprehensive income (loss)
Balances at January 1, 2013	\$ 1,418.3	\$ (173.9)	\$ (8.7)	\$ (106.9)	\$ (488.5)	\$ 640.3
Other comprehensive loss during the period, net of adjustments	(591.6)	(10.6)	22.0	(126.5)		(706.7)
Amounts reclassified from AOCI	38.6		(0.3)		27.6	65.9
Other comprehensive loss	(553.0)	(10.6)	21.7	(126.5)	27.6	(640.8)
Balances at June 30, 2013	\$ 865.3	\$ (184.5)	\$ 13.0	\$ (233.4)	\$ (460.9)	\$ (0.5)
Balances at January 1, 2014	\$ 878.1	\$ (167.0)	\$ (10.5)	\$ (361.5)	\$ (155.9)	\$ 183.2
Other comprehensive income during the period, net of adjustments	412.0		8.0	(12.4)		407.6
Amounts reclassified from AOCI	(41.5)	37.9	5.1		7.1	8.6
Other comprehensive income	370.5	37.9	13.1	(12.4)	7.1	416.2
Balances at June 30, 2014	\$ 1,248.6	\$ (129.1)	\$ 2.6	\$ (373.9)	\$ (148.8)	\$ 599.4

Noncontrolling Interest

Interest held by unaffiliated parties in consolidated entities are reflected in noncontrolling interest, which represents the noncontrolling partners share of the underlying net assets of our consolidated subsidiaries. Noncontrolling interest that is not redeemable is reported in the equity section of the consolidated statements of financial position.

The noncontrolling interest holders in certain of our subsidiaries maintain an equity interest that is redeemable at the option of the holder, which may be exercised on varying dates. Since redemption of the noncontrolling interest is outside of our control, this interest is presented on the consolidated statements of financial position line item titled Redeemable noncontrolling interest. If the interest were to be redeemed, we would be required to purchase such interest at a redemption value based on fair value or a formula that management intended to reasonably approximate fair value based on a fixed multiple of earnings over a measurement period. As such, the carrying value of the redeemable noncontrolling interest is compared to the redemption value at each reporting period. Any adjustments to the carrying amount of the redeemable noncontrolling interest for changes in redemption value prior to exercise of the redemption option are determined after the attribution of net income or loss of the subsidiary and are recognized in the redemption value as they occur. Adjustments to the carrying value of redeemable noncontrolling interest result in adjustments to additional paid-in capital and/or retained earnings. Adjustments are recorded in retained earnings to the extent the redemption value of the redeemable noncontrolling interest exceeds its fair value and will impact the numerator in our earnings per share calculations. All other adjustments to the redeemable noncontrolling interest are recorded in additional paid-in capital.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Following is a reconciliation of the changes in the redeemable noncontrolling interest (in millions):

Balance at January 1, 2013	\$	60.4
Net income attributable to redeemable noncontrolling interest		1.1
Distributions to redeemable noncontrolling interest		(1.5)
Foreign currency translation adjustment		(4.0)
Purchase of subsidiary shares from redeemable noncontrolling interest		(2.4)
Balance at June 30, 2013	\$	53.6
Balance at January 1, 2014	\$	247.2
Net income attributable to redeemable noncontrolling interest		5.2
Distributions to redeemable noncontrolling interest		(8.3)
Purchase of subsidiary shares from redeemable noncontrolling interest		(1.1)
Change in redemption value of redeemable noncontrolling interest		36.5
Foreign currency translation adjustment		2.9
Balance at June 30, 2014	\$	282.4

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.

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. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety considering factors specific to the asset or liability.

- **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, 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 at least one significant unobservable input for the asset or liability. Our Level 3 assets and liabilities include certain assets and liabilities priced using broker quotes or other valuation methods that utilize at least one significant unobservable input. These include 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, embedded derivatives and equity method real estate investments for which the fair value option was elected.

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.

Fair value estimates are made based on available market information and judgments about the financial instrument at a specific point in time. 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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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 2014.

Fixed Maturities

Fixed maturities include bonds, ABS, redeemable preferred stock and certain nonredeemable preferred securities. 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 of identical assets in active markets 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 an internal model using substantially all observable inputs or a matrix pricing valuation approach is used. In the matrix 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 and where at least one significant unobservable input is utilized, which are reflected in Level 3 and can include fixed maturities across all asset classes. As of June 30, 2014, less than 1% of our fixed maturities were valued using internal pricing models, which were classified as Level 3 assets accordingly.

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.

States 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 obligor credit ratings.

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 Treasury curve and risk spreads based on sector, rating and average life of the issuance.

RMBS, CMBS, Collateralized Debt Obligations 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.

Equity Securities

Equity securities include mutual funds, common stock, nonredeemable preferred stock and mandatory regulatory required investments. 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 or the net asset value (NAV), which are reflected in

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

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.

Derivatives

The fair values of exchange-traded derivatives are determined through quoted market prices, which are reflected in Level 1. Exchange-traded derivatives include futures that are settled daily such that their fair value is not reflected in the consolidated statements of financial position. The fair values of derivative instruments cleared through centralized clearinghouses are determined through market prices published by the clearinghouses, which are reflected in Level 2. The clearinghouses may utilize the overnight indexed swap (OIS) curve in their valuation. The fair values of bilateral OTC derivative instruments are determined using either pricing valuation models that utilize market observable inputs or broker quotes. The majority of our bilateral OTC 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 bilateral OTC 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 non-cleared 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. Our centrally cleared derivative contracts are conducted with regulated centralized clearinghouses, which provide for daily exchange of cash collateral equal to the difference in the daily market values of those contracts that eliminates the non-performance risk on these trades.

Interest Rate Contracts. For non-cleared 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. For centrally cleared contracts we use published prices from clearinghouses. These are reflected in Level 2. In addition, we have a limited number of complex inflation-linked interest rate swaps, interest rate collars and swaptions that are valued using broker quotes. These are reflected in Level 3.

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. Currency forwards are valued using observable market inputs, including forward currency exchange rates. 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.

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

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.

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. In addition, we have a limited number of total return swaps that are valued based on the observable quoted price of underlying equity indices. These are reflected in Level 2.

Other Investments

Other investments reported at fair value include seed money investments, other investment funds, commercial mortgage loans of consolidated VIEs and equity method real estate investments for which the fair value option was elected.

The fair value of seed money and other investment funds is determined using the NAV of the fund. The NAV of the funds represents the price at which we feel we would be able to initiate a transaction. Seed money investments in mutual funds for which the NAV is published are reflected in Level 1. Seed money investments in mutual funds in markets that do not have a published NAV and other investment funds, which are relatively illiquid due to restrictions on sale, are reflected in Level 2.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Commercial mortgage loans of consolidated VIEs and equity method real estate investments for which the fair value option was elected are reflected in Level 3. Fair value of the 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 equity method real estate investments consist of underlying real estate and debt. The real estate fair value is estimated using a discounted cash flow valuation model that utilizes public real estate market data inputs such as transaction prices, market rents, vacancy levels, leasing absorption, market cap rates and discount rates. The debt fair value is estimated using a discounted cash flow analysis based on our incremental borrowing rate for similar borrowing arrangements.

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.

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 included in separate account assets is recorded net of related mortgage encumbrances for which the fair value is estimated using discounted cash flow analysis based on our incremental borrowing rate for similar borrowing arrangements. The real estate within the separate accounts is reflected in Level 3.

Investment-Type Insurance Contracts

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). Risk margins are included in the policyholder behavior assumptions. The assumptions are based on a combination of historical data and actuarial judgment. The embedded

derivative liabilities are valued using stochastic models that incorporate a spread reflecting our own creditworthiness.

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.

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 that are valued 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.

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
June 30, 2014
(Unaudited)

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 June 30, 2014			
		Level 1	Fair value hierarchy level		Level 3
			Level 2	Level 3	
(in millions)					
Assets					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 780.3	\$ 417.7	\$ 362.6	\$ 39.6	
Non-U.S. governments	980.0		940.4	39.6	
States and political subdivisions	4,106.3		4,104.6	1.7	
Corporate	32,712.1	40.1	32,502.0	170.0	
Residential mortgage-backed securities	2,902.3		2,902.3		
Commercial mortgage-backed securities	4,043.4		4,036.7	6.7	
Collateralized debt obligations	443.5		375.0	68.5	
Other debt obligations	4,305.7		4,258.6	47.1	
Total fixed maturities, available-for-sale	50,273.6	457.8	49,482.2	333.6	
Fixed maturities, trading	647.8		488.2	159.6	
Equity securities, available-for-sale	117.4	31.2	68.7	17.5	
Equity securities, trading	805.8	115.4	690.4		
Derivative assets (1)	604.2		541.9	62.3	
Other investments (2)	365.2	7.2	223.4	134.6	
Cash equivalents (3)	855.8		855.8		
Sub-total excluding separate account assets	53,669.8	611.6	52,350.6	707.6	
Separate account assets	139,088.0	72,437.3	61,117.1	5,533.6	
Total assets	\$ 192,757.8	\$ 73,048.9	\$ 113,467.7	\$ 6,241.2	
Liabilities					
Investment-type insurance contracts (4)	\$ (37.6)	\$	\$	\$ (37.6)	
Derivative liabilities (1)	(863.7)		(839.0)	(24.7)	
Other liabilities (4)	(343.3)		(263.4)	(79.9)	
Total liabilities	\$ (1,244.6)	\$	\$ (1,102.4)	\$ (142.2)	
Net assets	\$ 191,513.2	\$ 73,048.9	\$ 112,365.3	\$ 6,099.0	

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

As of December 31, 2013

Assets/ (liabilities) measured at fair value	Fair value hierarchy level			Level 3
	Level 1	Level 2		
	(in millions)			
Assets				
Fixed maturities, available-for-sale:				
U.S. government and agencies	\$ 780.5	\$ 409.3	\$ 371.2	\$
Non-U.S. governments	996.8		949.3	47.5
States and political subdivisions	3,658.0		3,656.2	1.8
Corporate	31,919.0	40.3	31,714.7	164.0
Residential mortgage-backed securities	2,845.2		2,845.2	
Commercial mortgage-backed securities	4,026.4		4,024.8	1.6
Collateralized debt obligations	363.4		325.6	37.8
Other debt obligations	4,167.8		4,083.7	84.1
Total fixed maturities, available-for-sale	48,757.1	449.6	47,970.7	336.8
Fixed maturities, trading	563.1		393.2	169.9
Equity securities, available-for-sale	110.5	38.1	55.5	16.9
Equity securities, trading	716.9	105.1	611.8	
Derivative assets (1)	665.1		590.9	74.2
Other investments (2)	361.1	6.8	211.4	142.9
Cash equivalents (3)	1,459.0		1,459.0	
Sub-total excluding separate account assets	52,632.8	599.6	51,292.5	740.7
Separate account assets	130,018.4	67,215.1	57,538.1	5,265.2
Total assets	\$ 182,651.2	\$ 67,814.7	\$ 108,830.6	\$ 6,005.9
Liabilities				
Investment-type insurance contracts (4)	\$ (6.9)	\$	\$	\$ (6.9)
Derivative liabilities (1)	(1,024.6)		(985.0)	(39.6)
Other liabilities (4)	(322.1)		(248.2)	(73.9)
Total liabilities	\$ (1,353.6)	\$	\$ (1,233.2)	\$ (120.4)
Net assets	\$ 181,297.6	\$ 67,814.7	\$ 107,597.4	\$ 5,885.5

(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 certain credit default swaps and other swaps that are Level 3.

(2) Primarily includes seed money investments, other investment funds, commercial mortgage loans of consolidated VIEs and equity method investments reported at fair value.

(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
June 30, 2014
(Unaudited)

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 March 31, 2014	For the three months ended June 30, 2014					Ending asset/ (liability) balance as of June 30, 2014	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	Net purchases, sales, issuances and settlements (4) (in millions)	Transfers into Level 3	Transfers out of Level 3		
Assets								
Fixed maturities, available-for-sale:								
Non-U.S. governments	\$ 50.1	\$ (0.1)	\$ 0.3	\$ (10.7)	\$	\$	\$ 39.6	\$
States and political subdivisions	1.8			(0.1)			1.7	
Corporate	166.0	(0.1)	1.2	(21.4)	30.4	(6.1)	170.0	(0.1)
Commercial mortgage-backed securities	7.7	0.1	(0.1)	0.1		(1.1)	6.7	
Collateralized debt obligations	30.4		1.2	36.9			68.5	
Other debt obligations	47.7		0.7	(1.3)			47.1	
Total fixed maturities, available-for-sale	303.7	(0.1)	3.3	3.5	30.4	(7.2)	333.6	(0.1)
Fixed maturities, trading	174.6	1.1		(16.1)			159.6	(0.4)
Equity securities, available-for-sale	17.6		(0.3)		0.2		17.5	
Derivative assets	65.1	(2.9)		0.1			62.3	(2.7)
Other investments	133.6	3.2		(2.2)			134.6	3.3
Separate account assets (2)	5,341.0	89.2	0.2	104.8	0.1	(1.7)	5,533.6	93.1
Liabilities								
Investment-type insurance contracts	(25.8)	(19.6)		7.8			(37.6)	(19.4)
Derivative liabilities	(34.4)	8.9	1.0	(0.2)			(24.7)	8.6
Other liabilities (3)	(75.9)	(4.0)					(79.9)	(4.0)

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	Beginning asset/ (liability) balance as of March 31, 2013	For the three months ended June 30, 2013				Transfers into Level 3	Transfers out of Level 3	Ending asset/ (liability) balance as of June 30, 2013	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	Net purchases, sales, and settlements (4) (in millions)	issuances				
Assets									
Fixed maturities, available-for-sale:									
Non-U.S. governments	\$ 40.4	\$ (0.1)	\$ (0.8)	\$ 5.2	\$	\$	\$ 44.7	\$	
States and political subdivisions	1.9		(0.1)	(0.1)			1.7		
Corporate	167.6	(1.7)	0.4	(24.8)	53.1	(26.5)	168.1	(1.9)	
Collateralized debt obligations	75.2		0.4	(23.0)	10.3	(22.2)	40.7		
Other debt obligations	15.9		0.7	(0.4)	2.2		18.4		
Total fixed maturities, available-for-sale	301.0	(1.8)	0.6	(43.1)	65.6	(48.7)	273.6	(1.9)	
Fixed maturities, trading	169.5	1.2					170.7	1.1	
Equity securities, available-for-sale	16.1		0.8				16.9	(0.1)	
Derivative assets	67.2	(10.8)		0.5			56.9	(10.6)	
Other investments	110.9	5.9		(0.3)			116.5	5.9	
Separate account assets (2)	4,659.2	173.6	0.1	2.6	6.4	(0.2)	4,841.7	173.5	
Liabilities									
Investment-type insurance contracts	(117.8)	41.9		1.7			(74.2)	41.5	
Derivative liabilities	(75.6)	4.5	(0.8)	1.9			(70.0)	4.4	
Other liabilities (3)	(54.2)	(5.4)					(59.6)	(5.4)	

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	Beginning asset/ (liability) balance as of December 31, 2013	For the six months ended June 30, 2014				Transfers into Level 3	Transfers out of Level 3	Ending asset/ (liability) balance as of June 30, 2014	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	Net purchases, sales, issuances and settlements (4)	(in millions)				
Assets									
Fixed maturities, available-for-sale:									
Non-U.S. governments	\$ 47.5	\$ (0.1)	\$	\$ (7.8)	\$	\$	\$ 39.6	\$ (0.1)	
States and political subdivisions	1.8			(0.1)			1.7		
Corporate	164.0	(0.2)	1.1	(19.7)	30.9	(6.1)	170.0	(0.2)	
Commercial mortgage-backed securities	1.6	(0.6)	1.1	(0.4)	6.1	(1.1)	6.7	(0.7)	
Collateralized debt obligations	37.8		1.3	36.9		(7.5)	68.5		
Other debt obligations	84.1		1.1	(8.4)		(29.7)	47.1		
Total fixed maturities, available-for-sale	336.8	(0.9)	4.6	0.5	37.0	(44.4)	333.6	(1.0)	
Fixed maturities, trading	169.9	5.8		(16.1)			159.6	3.8	
Equity securities, available-for-sale	16.9		0.4		0.2		17.5		
Derivative assets	74.2	(12.0)		0.1			62.3	(12.0)	
Other investments	142.9	2.8		(11.1)			134.6	2.8	
Separate account assets (2)	5,265.2	191.4	0.1	82.3	2.1	(7.5)	5,533.6	196.4	
Liabilities									
Investment-type insurance contracts	(6.9)	(47.1)		16.4			(37.6)	(46.8)	
Derivative liabilities	(39.6)	13.8	1.3	(0.2)			(24.7)	13.5	
Other liabilities (3)	(73.9)	(6.0)					(79.9)	(6.0)	

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	Beginning asset/ (liability) balance as of December 31, 2012	For the six months ended June 30, 2013					Ending asset/ (liability) balance as of June 30, 2013	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	Net purchases, sales, issuances and settlements (4) (in millions)	Transfers into Level 3	Transfers out of Level 3		
Assets								
Fixed maturities, available-for-sale:								
Non-U.S. governments	\$ 44.3	\$ (0.1)	\$ (0.5)	\$ 1.0	\$	\$	\$ 44.7	\$ (0.1)
States and political subdivisions	1.9		(0.1)	(0.1)			1.7	
Corporate	174.5	(4.8)	(9.7)	(42.4)	100.6	(50.1)	168.1	(2.0)
Collateralized debt obligations	77.6	2.1	7.5	(56.0)	31.7	(22.2)	40.7	
Other debt obligations	14.7		2.4	(0.9)	2.2		18.4	
Total fixed maturities, available-for-sale	313.0	(2.8)	(0.4)	(98.4)	134.5	(72.3)	273.6	(2.1)
Fixed maturities, trading	166.8	3.9					170.7	3.9
Equity securities, available-for-sale	15.3		1.6				16.9	(0.1)
Derivative assets	75.1	(22.3)		4.1			56.9	(22.9)
Other investments	113.9	5.3		(2.7)			116.5	5.3
Separate account assets (2)	4,616.0	292.6	(0.1)	(74.4)	7.8	(0.2)	4,841.7	290.3
Liabilities								
Investment-type insurance contracts	(170.5)	93.6		2.7			(74.2)	92.1
Derivative liabilities	(102.6)	30.3	(0.5)	2.8			(70.0)	29.6
Other liabilities (3)	(39.6)	(20.0)					(59.6)	(20.0)

(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 operation.

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

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

For the three months ended June 30, 2014

	Purchases	Sales	Issuances (in millions)	Settlements	Net purchases, sales, issuances and settlements
Assets					
Fixed maturities, available-for-sale:					
Non-U.S. governments	\$ 0.4	\$ (10.8)	\$	\$ (0.3)	\$ (10.7)
State and political subdivisions				(0.1)	(0.1)
Corporate	10.4	(27.8)		(4.0)	(21.4)
Commercial mortgage-backed securities				0.1	0.1
Collateralized debt obligations	51.6			(14.7)	36.9
Other debt obligations				(1.3)	(1.3)
Total fixed maturities, available-for-sale	62.4	(38.6)		(20.3)	3.5
Fixed maturities, trading				(16.1)	(16.1)
Derivative assets	0.1				0.1
Other investments	0.2			(2.4)	(2.2)
Separate account assets (5)	160.4	(50.0)	(40.2)	34.6	104.8
Liabilities					
Investment-type insurance contracts			7.4	0.4	7.8
Derivative liabilities	(0.2)				(0.2)

For the three months ended June 30, 2013

	Purchases	Sales	Issuances (in millions)	Settlements	Net purchases, sales, issuances and settlements
Assets					
Fixed maturities, available-for-sale:					
Non-U.S. governments	\$ 5.5	\$	\$	\$ (0.3)	\$ 5.2
State and political subdivisions				(0.1)	(0.1)
Corporate	7.2	(22.3)		(9.7)	(24.8)
Collateralized debt obligations	17.0	(15.0)		(25.0)	(23.0)
Other debt obligations				(0.4)	(0.4)
Total fixed maturities, available-for-sale	29.7	(37.3)		(35.5)	(43.1)
Derivative assets	0.5				0.5
Other investments	2.4			(2.7)	(0.3)
Separate account assets (5)	43.1	(31.9)	(1.7)	(6.9)	2.6
Liabilities					
Investment-type insurance contracts			0.5	1.2	1.7
Derivative liabilities	(1.5)	3.4			1.9

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

For the six months ended June 30, 2014

	Purchases	Sales	Issuances (in millions)	Settlements	Net purchases, sales, issuances and settlements
Assets					
Fixed maturities, available-for-sale:					
Non-U.S. government	\$ 3.6	\$ (10.8)	\$	\$ (0.6)	\$ (7.8)
States and political subdivisions				(0.1)	(0.1)
Corporate	18.0	(33.7)		(4.0)	(19.7)
Commercial mortgage-backed securities				(0.4)	(0.4)
Collateralized debt obligations	51.6			(14.7)	36.9
Other debt obligations				(8.4)	(8.4)
Total fixed maturities, available-for-sale	73.2	(44.5)		(28.2)	0.5
Fixed maturities, trading				(16.1)	(16.1)
Derivative assets	0.1				0.1
Other investments	0.2			(11.3)	(11.1)
Separate account assets (5)	238.7	(130.2)	(93.6)	67.4	82.3
Liabilities					
Investment-type insurance contracts			14.5	1.9	16.4
Derivative liabilities	(0.2)				(0.2)

For the six months ended June 30, 2013

	Purchases	Sales	Issuances (in millions)	Settlements	Net purchases, sales, issuances and settlements
Assets					
Fixed maturities, available-for-sale:					
Non-U.S. government	\$ 5.5	\$ (3.9)	\$	\$ (0.6)	\$ 1.0
State and political subdivisions				(0.1)	(0.1)
Corporate	11.4	(31.7)		(22.1)	(42.4)
Collateralized debt obligations	17.0	(47.4)		(25.6)	(56.0)
Other debt obligations				(0.9)	(0.9)
Total fixed maturities, available-for-sale	33.9	(83.0)		(49.3)	(98.4)
Derivative assets	7.2	(3.1)			4.1
Other investments	2.6			(5.3)	(2.7)
Separate account assets (5)	109.6	(168.7)	(6.2)	(9.1)	(74.4)
Liabilities					
Investment-type insurance contracts			0.2	2.5	2.7
Derivative liabilities	(3.1)	5.9			2.8

(5) Issuances and settlements include amounts related to mortgage encumbrances associated with real estate in our separate accounts.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Transfers

Transfers of assets and liabilities measured at fair value on a recurring basis between fair value hierarchy levels are summarized below.

	Transfers out of Level 1 into Level 2	Transfers out of Level 1 into Level 3	For the three months ended June 30, 2014		Transfers out of Level 3 into Level 1	Transfers out of Level 3 into Level 2
			Transfers out of Level 2 into Level 1	Transfers out of Level 2 into Level 3		
(in millions)						
Assets						
Fixed maturities, available-for- sale:						
Corporate	\$	\$	\$	\$ 30.4	\$	\$ 6.1
Commercial mortgage-backed securities						1.1
Total fixed maturities, available-for-sale				30.4		7.2
Equity securities, available-for- sale				0.2		
Separate account assets	11.7		0.6	0.1		1.7

	Transfers out of Level 1 into Level 2	Transfers out of Level 1 into Level 3	For the three months ended June 30, 2013		Transfers out of Level 3 into Level 1	Transfers out of Level 3 into Level 2
			Transfers out of Level 2 into Level 1	Transfers out of Level 2 into Level 3		
(in millions)						
Assets						
Fixed maturities, available-for- sale:						
Corporate	\$	\$	\$	\$ 53.1	\$	\$ 26.5
Collateralized debt obligations				10.3		22.2
Other debt obligations				2.2		
Total fixed maturities, available-for-sale				65.6		48.7
Separate account assets	0.4	0.1	0.2	6.3		0.2

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

	Transfers out of Level 1 into Level 2	Transfers out of Level 1 into Level 3	For the six months ended June 30, 2014		Transfers out of Level 3 into Level 1	Transfers out of Level 3 into Level 2
			Transfers out of Level 2 into Level 1	Transfers out of Level 2 into Level 3		
(in millions)						
Assets						
Fixed maturities, available-for- sale:						
Corporate	\$	\$	\$	\$	30.9	\$
Commercial mortgage-backed securities					6.1	1.1
Collateralized debt obligations						7.5
Other debt obligations						29.7
Total fixed maturities, available-for-sale					37.0	44.4
Equity securities, available-for-sale					0.2	
Separate account assets	15.4		53.8		2.1	7.5

	Transfers out of Level 1 into Level 2	Transfers out of Level 1 into Level 3	For the six months ended June 30, 2013		Transfers out of Level 3 into Level 1	Transfers out of Level 3 into Level 2
			Transfers out of Level 2 into Level 1	Transfers out of Level 2 into Level 3		
(in millions)						
Assets						
Fixed maturities, available-for- sale:						
Corporate	\$	\$	\$	\$	100.6	\$
Collateralized debt obligations					31.7	22.2
Other debt obligations					2.2	
Total fixed maturities, available-for-sale					134.5	72.3
Separate account assets	243.8	0.1	4.8		7.7	0.2

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

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.

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

Assets transferred into Level 3 during the three and six months ended June 30, 2014 and 2013, primarily included those assets for which we are now unable to obtain pricing from a recognized third party pricing vendor as well as assets that were previously priced using a matrix valuation approach that may no longer be relevant when applied to asset-specific situations.

Assets transferred out of Level 3 during the three and six months ended June 30, 2014 and 2013, included those for which we are now able to obtain pricing from a recognized third party pricing vendor or from internal models using substantially all market observable information.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Quantitative Information about Level 3 Fair Value Measurements

The following table provides quantitative information about the significant unobservable inputs used for recurring fair value measurements categorized within Level 3, excluding assets and liabilities for which significant quantitative unobservable inputs are not developed internally, which primarily consists of those valued using broker quotes. Refer to Assets and liabilities measured at fair value on a recurring basis for a complete valuation hierarchy summary.

As of June 30, 2014					
	Assets / (liabilities) measured at fair value (in millions)	Valuation technique(s)	Unobservable input description	Input/range of inputs	Weighted average
Assets					
Fixed maturities, available-for-sale:					
Non-U.S. governments	\$ 11.1	Discounted cash flow	Discount rate (1)	1.9%	1.9%
			Illiquidity premium	50 basis points (bps)	50bps
Corporate	73.5	Discounted cash flow	Discount rate (1)	1.1%-7.5%	3.9%
			Comparability adjustment	0bps-4bps	0bps
			Illiquidity premium	0bps-25bps	15bps
Commercial mortgage-backed securities	5.3	Discounted cash flow	Discount rate (1)	4.0%-13.0%	13.0%
Other debt obligations	32.4	Discounted cash flow	Discount rate (1)	1.2%-15.0%	4.6%
			Illiquidity premium	0bps-50bps	38bps
Fixed maturities, trading	25.4	Discounted cash flow	Discount rate (1)	1.2%-127.7%	3.6%
			Illiquidity premium	0bps-1,400bps	300bps
	110.4	See note (2)			

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

As of June 30, 2014

	Assets / (liabilities) measured at fair value (in millions)	Valuation technique(s)	Unobservable input description	Input/range of inputs	Weighted average
Other investments	56.1	Discounted cash flow - commercial mortgage loans of consolidated VIEs	Discount rate (1)	4.1%	4.1%
	78.5	Discounted cash flow - equity method real estate investments	Illiquidity premium Discount rate (1)	153bps 7.5%-8.1%	153bps 7.8%
			Terminal capitalization rate	5.5%-6.8%	6.1%
			Average market rent growth rate	2.7%-3.3%	3.0%
		Discounted cash flow - equity method real estate investment - debt	Loan to value	39.3%-60.6%	49.9%
			Credit spread rate	1.8%-2.0%	1.9%
Separate account assets	5,363.0	Discounted cash flow - mortgage loans	Discount rate (1)	0.7%-5.3%	3.1%
			Illiquidity premium	0bps-60bps	11bps
			Credit spread rate	58bps-479bps	215bps
		Discounted cash flow - real estate	Discount rate (1)	6.0%-17.5%	7.5%
			Terminal capitalization rate	4.5%-9.0%	6.5%
			Average market rent growth rate	1.4%-5.0%	3.2%
		Discounted cash flow - real estate debt	Loan to value	1.0%-64.2%	49.2%
			Credit spread rate	1.5%-4.7%	3.2%

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

As of June 30, 2014					
	Assets / (liabilities) measured at fair value (in millions)	Valuation technique(s)	Unobservable input description	Input/range of inputs	Weighted average
Liabilities					
Investment-type insurance contracts	(37.6)	Discounted cash flow	Long duration interest rate	3.2%-3.3% (3)	
			Long-term equity market volatility	15.0%-37.2%	
			Non-performance risk	0.1%-1.1%	
			Utilization rate	See note (4)	
			Lapse rate	0.5%-14.6%	
			Mortality rate	See note (5)	
Derivative liabilities	(12.4)	See note (2)			
Other liabilities	(79.9)	See note (2)			

As of December 31, 2013					
	Assets / (liabilities) measured at fair value (in millions)	Valuation technique(s)	Unobservable input description	Input/range of inputs	Weighted average
Assets					
Fixed maturities, available-for-sale:					
Non-U.S. governments	\$ 11.7	Discounted cash flow	Discount rate (1)	2.0%	2.0%
			Illiquidity premium	50 basis points (bps)	50bps
Corporate	70.1	Discounted cash flow	Discount rate (1)	1.9%-7.7%	4.4%
			Illiquidity premium	0bps-25bps	15bps
			Earnings before interest, taxes, depreciation and amortization multiple	0x-4.5x	0.2x
			Comparability adjustment	0bps - 125bps	43bps
			Probability of default	0%-100%	5.4%
			Potential loss severity	0%-16%	0.9%
Commercial mortgage-backed securities	1.6	Discounted cash flow	Discount rate (1)	1.5%-4.5%	1.5%

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

As of December 31, 2013

	Assets / (liabilities) measured at fair value (in millions)	Valuation technique(s)	Unobservable input description	Input/range of inputs	Weighted average
Collateralized debt obligations	13.6	Discounted cash flow	Discount rate (1)	1.5%	1.5%
			Illiquidity premium	400bps	400bps
Other debt obligations	33.6	Discounted cash flow	Discount rate (1)	2.0%-15.0%	6.7%
			Illiquidity premium	0bps-50bps	11bps
Fixed maturities, trading	36.2	Discounted cash flow	Discount rate (1)	1.6%-83.0%	3.4%
	110.4	See note (2)	Illiquidity premium	0bps-1,400bps	370bps
Other investments	68.1	Discounted cash flow - commercial mortgage loans of consolidated VIEs	Discount rate (1)	4.8%	4.8%
	74.8	Discounted cash flow - equity method real estate investment	Illiquidity premium	94bps	94bps
			Discount rate (1)	7.8%-8.1%	7.9%
			Terminal capitalization rate	5.5%-6.8%	6.1%
			Average market rent growth rate	3.5%-3.6%	3.6%
		Discounted cash flow - equity method real estate investment debt	Loan to value	40.5%-61.0%	50.7%
			Credit spread rate	1.5%-2.0%	1.8%

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

As of December 31, 2013

	Assets / (liabilities) measured at fair value (in millions)	Valuation technique(s)	Unobservable input description	Input/range of inputs	Weighted average		
Separate account assets	5,090.4	Discounted cash flow - mortgage loans	Discount rate (1)	0.6%-5.6%	3.3%		
			Illiquidity premium	0bps-60bps	12bps		
			Credit spread rate	32bps-440bps	214bps		
		Discounted cash flow - real estate			Discount rate (1)	6.0%-16.0%	7.6%
					Terminal capitalization rate	4.5%-9.0%	6.6%
					Average market rent growth rate	2.4%-4.7%	3.0%
					Loan to value	11.0%-55.9%	50.3%
Discounted cash flow - real estate debt			Credit spread rate	1.5%-5.2%	3.3%		
Liabilities							
Investment-type insurance contracts	(6.9)	Discounted cash flow	Long duration interest rate	3.8%-3.9% (3)			
			Long-term equity market volatility	15.0%-40.1%			
			Non-performance risk	0.2%-1.2%			
			Utilization rate	See note (4)			
			Lapse rate	0.5%-14.6%			
			Mortality rate	See note (5)			
Derivative liabilities	(19.9)	See note (2)					
Other liabilities	(73.9)	See note (2)					

(1) Represents market comparable interest rate or an index adjusted rate used as the base rate in the discounted cash flow analysis prior to any credit spread, illiquidity or other adjustments, where applicable.

(2) Relates to a consolidated collateralized private investment vehicle that is a VIE. Fixed maturities, trading represents the underlying collateral of the investment structure and consists of high-grade fixed maturity investments, which are over-collateralized based on outstanding notes priced at par. The derivative liability represents credit default swaps that are valued using a correlation model to the credit default swap (CDS) Index (CDX) and inputs to the valuation are based on observable market data such as the end of period swap curve, CDS constituents of the index and spread levels of the index, as well as CDX tranche spreads. The other liabilities represent obligations to third party note holders due at maturity or termination of the trust. The value of the obligations reflect the third parties' interest in the investment structure.

(3) Represents the range of rate curves used in the valuation analysis that we have determined market participants would use when pricing the instrument. Derived from interpolation between observable 20 and 30-year swap rates.

(4) This input factor is the number of contractholders taking withdrawals as well as the amount and timing of the withdrawals and a range does not provide a meaningful presentation.

(5) This input is based on an appropriate industry mortality table and a range does not provide a meaningful presentation.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Market comparable discount rates are used as the base rate in the discounted cash flows used to determine the fair value of certain assets. Increases or decreases in the credit spreads on the comparable assets could cause the fair value of the assets to significantly decrease or increase, respectively. Additionally, we may adjust the base discount rate or the modeled price by applying an illiquidity premium given the highly structured nature of certain assets. Increases or decreases in this illiquidity premium could cause significant decreases or increases, respectively, in the fair value of the asset.

Embedded derivatives can be either assets or liabilities within the investment-type insurance contracts line item, depending on certain inputs at the reporting date. Increases to an asset or decreases to a liability are described as increases to fair value. Increases or decreases in market volatilities could cause significant decreases or increases, respectively, in the fair value of embedded derivatives in investment-type insurance contracts. Long duration interest rates are used as the mean return when projecting the growth in the value of associated account value and impact the discount rate used in the discounted future cash flows valuation. The amount of claims will increase if account value is not sufficient to cover guaranteed withdrawals. Increases or decreases in risk free rates could cause the fair value of the embedded derivative to significantly increase or decrease, respectively. Increases or decreases in our own credit risks, which impact the rates used to discount future cash flows, could significantly increase or decrease, respectively, the fair value of the embedded derivative. All of these changes in fair value would impact net income.

Decreases or increases in the mortality rate assumption could cause the fair value of the embedded derivative to decrease or increase, respectively. Decreases or increases in the overall lapse rate assumption could cause the fair value of the embedded derivative to decrease or increase, respectively. The lapse rate assumption varies dynamically based on the relationship of the guarantee and associated account value. A stronger or weaker dynamic lapse rate assumption could cause the fair value of the embedded derivative to decrease or increase, respectively. The utilization rate assumption includes how many contractholders will take withdrawals, when they will take them and how much of their benefit they will take. Increases or decreases in the assumption of the number of contractholders taking withdrawals could cause the fair value of the embedded derivative to decrease or increase, respectively. Assuming contractholders take withdrawals earlier or later could cause the fair value of the embedded derivative to decrease or increase, respectively. Assuming contractholders take more or less of their benefit could cause the fair value of the embedded derivative to decrease or increase, respectively.

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain assets are measured at fair value on a nonrecurring basis. During the six months ended June 30, 2014, certain mortgage loans had been marked to fair value of \$23.8 million. The net impact of impairments and improvements in estimated fair value of previously impaired loans resulted in a net gain of \$0.2 million and \$0.6 million for the three and six months ended June 30, 2014, respectively, that was recorded in net realized capital gains (losses) as part of the mortgage loan valuation allowance. This includes the impact of certain loans no longer on our books. 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 significant unobservable inputs. The fair value of the underlying collateral is determined based on a discounted cash flow valuation either from an external broker opinion of value or an internal model. Significant inputs used in the discounted cash flow calculation include: a discount rate, terminal capitalization rate and average market rent growth. The ranges of inputs used in the fair value measurements for the mortgage loans marked to fair value during the six months ended June 30, 2014, were:

Discount rate = 11.0%

Terminal capitalization rate = 7.3% - 9.0%

Average market rent growth = 3.0% - 10.9%

During the six months ended June 30, 2013, certain mortgage loans had been marked to fair value of \$78.0 million. The net impact of impairments and improvements in estimated fair value of previously impaired loans resulted in a net loss of \$8.9 million and \$17.7 million for the three and six months ended June 30, 2013, respectively, that was recorded in net realized capital gains (losses) as part of the mortgage loan valuation allowance. This includes the impact of certain loans no longer on our books. 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 significant unobservable inputs.

Discount rate = 9.5% - 20.0%

Terminal capitalization rate = 7.5% - 10.5%

Average market rent growth = 1.0% - 7.0%

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

During the six months ended June 30, 2013, certain mortgage servicing rights had been written down to fair value of \$7.9 million. The net impact of impairments and improvements in estimated fair value of previously impaired mortgage servicing rights resulted in a net gain of \$1.1 million and \$1.3 million for the three and six months ended June 30, 2013, 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. The discount rate used in calculating the present value of the future servicing cash flows was 3.8% for the six months ended June 30, 2013.

Fair Value Option

We elected fair value accounting for certain assets and liabilities of 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 \$56.1 million and \$52.7 million as of June 30, 2014, and \$68.1 million and \$64.0 million as of December 31, 2013, respectively. The change in fair value of the loans resulted in a \$0.6 million and \$2.1 million pre-tax gain for the three months ended June 30, 2014 and 2013, respectively, and a \$(0.7) million and \$1.6 million pre-tax gain (loss) for the six months ended June 30, 2014 and 2013, 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. Interest income recorded on these commercial mortgage loans was \$1.1 million and \$1.4 million for the three months ended June 30, 2014 and 2013, respectively, and \$2.2 million and \$2.9 million for the six months ended June 30, 2014 and 2013, respectively.

The fair value and aggregate unpaid principal amounts of obligations for which the fair value option has been elected were \$99.2 million and \$163.1 million as of June 30, 2014, and \$104.9 million and \$174.4 million as of December 31, 2013, respectively. For the three months ended June 30, 2014 and 2013, the change in fair value of the obligations resulted in a pre-tax loss of \$4.7 million and \$5.1 million, which includes a pre-tax loss of \$4.0 million and \$5.4 million related to instrument-specific credit risk that is estimated based on credit spreads and quality ratings, respectively. For the six months ended June 30, 2014 and 2013, the change in fair value of the obligations resulted in a pre-tax loss of \$5.7 million and \$19.3 million, which includes a pre-tax loss of \$6.0 million and \$20.0 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 \$0.6 million and \$0.9 million for the three months ended June 30, 2014 and 2013, respectively, and \$1.1 million and \$1.9 million for the six months ended June 30, 2014 and 2013, respectively.

We invest in real estate ventures for the purpose of earning investment returns and for capital appreciation. We elected the fair value option for certain ventures that are subject to the equity method of accounting because the nature of the investments are to add value to the properties and

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

generate income from the operations of the properties. Other equity method real estate investments are not fair valued because the investments mainly generate income from the operations of the underlying properties. These investments are reported with other investments in the consolidated statements of financial position. The changes in fair value are reported in net investment income on the consolidated statements of operations. The fair value of the equity method investments for which the fair value option has been elected was \$78.5 million and \$74.8 million as of June 30, 2014 and December 31, 2013, respectively. The change in fair value of the investments resulted in a \$2.8 million and \$3.8 million pre-tax gain for the three months ended June 30, 2014 and 2013, respectively, and \$3.6 million and \$3.7 million pre-tax gain for the six months ended June 30, 2014 and 2013, respectively.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Financial Instruments Not Reported at Fair Value

The carrying value and estimated fair value of financial instruments not recorded at fair value on a recurring basis but required to be disclosed at fair value were as follows:

	Carrying amount	Fair value	June 30, 2014		
			Level 1 (in millions)	Level 2	Level 3
Assets (liabilities)					
Mortgage loans	\$ 11,592.1	\$ 12,056.0	\$	\$	\$ 12,056.0
Policy loans	836.1	1,003.8			1,003.8
Other investments	196.6	197.1		163.3	33.8
Cash and cash equivalents	886.5	886.5	886.5		
Investments-type insurance contracts	(28,980.2)	(29,232.8)		(5,615.2)	(23,617.6)
Short-term debt	(148.6)	(148.6)		(148.6)	
Long-term debt	(2,529.4)	(2,752.0)		(2,671.5)	(80.5)
Separate account liabilities	(127,837.1)	(126,434.4)			(126,434.4)
Bank deposits	(1,933.7)	(1,941.2)	(1,274.3)	(666.9)	
Cash collateral payable	(51.5)	(51.5)	(51.5)		

	Carrying amount	Fair value	December 31, 2013		
			Level 1 (in millions)	Level 2	Level 3
Assets (liabilities)					
Mortgage loans	\$ 11,533.6	\$ 11,773.5	\$	\$	\$ 11,773.5
Policy loans	859.7	963.3			963.3
Other investments	174.0	174.7		140.9	33.8
Cash and cash equivalents	912.8	912.8	912.8		
Investments-type insurance contracts	(29,909.6)	(30,093.1)		(5,902.2)	(24,190.9)
Short-term debt	(150.6)	(150.6)		(150.6)	
Long-term debt	(2,601.4)	(2,692.1)		(2,639.0)	(53.1)
Separate account liabilities	(119,500.7)	(118,059.7)			(118,059.7)
Bank deposits	(1,949.0)	(1,951.1)	(1,252.2)	(698.9)	
Cash collateral payable	(32.5)	(32.5)	(32.5)		

Mortgage Loans

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

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. These are reflected in Level 3.

Policy Loans

Fair values of policy loans are estimated by discounting expected cash flows using a risk-free rate based on the Treasury curve. The expected cash flows reflect an estimate of timing of the repayment of the loans. These are reflected in Level 3.

Other Investments

The fair value of commercial loans and certain consumer loans included in other investments is calculated by discounting expected cash flows through the estimated maturity date using market interest rates that reflect the credit and interest rate risk inherent in the loans. The estimate of term to maturity is based on historical experience, adjusted as required, for current economic and lending conditions. The effect of nonperforming loans is considered in assessing the credit risk inherent in the fair value estimate. These are reflected in Level 3. The carrying value of the remaining investments reported in this line item approximate their fair value and are of a

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

short-term nature. These are reflected in Level 2.

Cash and Cash Equivalents

Certain cash equivalents not reported at fair value include short-term investments with maturities of less than three months for which public quotations are not available to use in determining fair value. Because of the highly liquid nature of these assets, carrying amounts are used to approximate fair value, which are reflected in Level 2. The carrying amounts of the remaining cash and cash equivalents that are not reported at fair value on a recurring basis approximate their fair value, which are reflected in Level 1 given the nature of cash.

Investment-Type Insurance Contracts

The fair values of our reserves and liabilities for investment-type insurance contracts are determined via a third party pricing vendor or using discounted cash flow analyses when we are unable to find a price from third party pricing vendors. Third party pricing on various outstanding medium-term notes and funding agreements is based on observable inputs such as benchmark yields and spreads based on reported trades for our medium-term notes and funding agreement issuances. These are reflected in Level 2. The discounted cash flow analyses for the remaining contracts is 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. These are reflected in Level 3. 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.

Short-Term Debt

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, which is reflected in Level 2.

Long-Term Debt

Long-term debt primarily includes senior note issuances for which the fair values are determined using inputs that are observable in the market or that can be derived from or corroborated with observable market data. These are reflected in Level 2. Additionally, our long-term debt includes non-recourse mortgages and notes payable that are primarily financings for real estate developments for which the fair values are estimated using discounted cash flow analysis based on our incremental borrowing rate for similar borrowing arrangements. These are reflected in Level 3.

Separate Account Liabilities

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 Treasury securities at maturities aligned with the estimated timing of fee collection. These are reflected in Level 3.

Bank Deposits

The fair value of deposits of our Principal Bank subsidiary with no stated maturity is equal to the amount payable on demand (i.e., their carrying amounts). These are reflected in Level 1. 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. These are reflected in Level 2.

Table of Contents

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements
June 30, 2014
(Unaudited)

Cash Collateral Payable

The carrying amount of the payable associated with our obligation to return the cash collateral received under derivative credit support annex (collateral) agreements approximates its fair value, which is reflected in Level 1.

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.