PRINCIPAL FINANCIAL GROUP INC
Form 10-Q
May 05, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

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	**42-1520346**
(State or other jurisdiction of incorporation or organization)	(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 x No o

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 x No o

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

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

The total number of shares of the registrant s Common Stock, $0.01 par value, outstanding as of April 28, 2010, was 319,728,326.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Principal Financial Group, Inc.

Consolidated Statements of Financial Position

	March 31, 2010 (Unaudited)	December 31, 2009
	(in millions)	
Assets		
Fixed maturities, available-for-sale (2010 includes $262.8 million related to consolidated variable interest entities)	**$ 47,765.4**	$ 46,220.6
Fixed maturities, trading (2010 includes $164.7 million related to consolidated variable interest entities)	**1,359.4**	1,032.4
Equity securities, available-for-sale	**181.9**	214.0
Equity securities, trading (2010 includes $93.6 million related to consolidated variable interest entities)	**235.4**	221.5
Mortgage loans	**11,559.2**	11,845.6
Real estate	**1,048.5**	1,034.6
Policy loans	**895.7**	902.5
Other investments (2010 includes $117.4 million related to consolidated variable interest entities of which $117.3 million are measured at fair value under the fair value option)	**2,479.3**	2,465.3
Total investments	**65,524.8**	63,936.5
Cash and cash equivalents (2010 includes $106.8 million related to consolidated variable interest entities)	**1,629.7**	2,240.4
Accrued investment income (2010 includes $1.6 million related to consolidated variable interest entities)	**724.0**	691.9
Premiums due and other receivables (2010 includes $14.8 million related to consolidated variable interest entities)	**1,190.7**	1,065.4
Deferred policy acquisition costs	**3,554.2**	3,681.4
Property and equipment	**480.5**	489.3
Goodwill	**384.0**	386.4
Other intangibles	**851.9**	851.7
Separate account assets	**65,245.7**	62,738.5
Other assets	**1,251.2**	1,677.9
Total assets	**$ 140,836.7**	$ 137,759.4
Liabilities		
Contractholder funds	**$ 39,367.1**	$ 39,801.9
Future policy benefits and claims	**19,228.6**	19,248.3
Other policyholder funds	**568.6**	559.2
Short-term debt	**131.6**	101.6
Long-term debt	**1,578.3**	1,584.6
Income taxes currently payable	**2.4**	2.8
Deferred income taxes (2010 includes $2.7 million related to consolidated variable interest entities)	**126.6**	120.2
Separate account liabilities	**65,245.7**	62,738.5

Other liabilities (2010 includes $415.2 million related to consolidated variable interest entities of which $132.4 million are measured at fair value under the fair value option)		**5,899.6**		5,585.9
Total liabilities		**132,148.5**		129,743.0
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 2010 and 2009				
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 2010 and 2009		**0.1**		0.1
Common stock, par value $.01 per share - 2,500.0 million shares authorized, 447.8 million and 447.0 million shares issued, and 319.7 million and 319.0 million shares outstanding in 2010 and 2009		**4.5**		4.5
Additional paid-in capital		**9,512.5**		9,492.9
Retained earnings		**4,340.8**		4,160.7
Accumulated other comprehensive loss		**(577.9)**		(1,042.0)
Treasury stock, at cost (128.1 million and 128.0 million shares in 2010 and 2009, respectively)		**(4,724.4)**		(4,722.7)
Total stockholders equity attributable to Principal Financial Group, Inc.		**8,555.6**		7,893.5
Noncontrolling interest		**132.6**		122.9
Total stockholders equity		**8,688.2**		8,016.4
Total liabilities and stockholders equity	**$**	**140,836.7**	$	137,759.4

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Operations

(Unaudited)

		For the three months ended March 31, 2010		2009
		(in millions, except per share data)		
Revenues				
Premiums and other considerations	$	**878.9**	$	949.9
Fees and other revenues		**567.6**		473.5
Net investment income		**863.0**		828.5
Net realized capital gains, excluding impairment losses on available-for-sale securities		**33.7**		32.7
Total other-than-temporary impairment losses on available-for-sale securities		**(84.6)**		(146.6)
Portion of impairment losses on fixed maturities, available-for-sale recognized in other comprehensive income		**5.4**		50.6
Net impairment losses on available-for-sale securities		**(79.2)**		(96.0)
Net realized capital losses		**(45.5)**		(63.3)
Total revenues		**2,264.0**		2,188.6
Expenses				
Benefits, claims and settlement expenses		**1,275.3**		1,306.6
Dividends to policyholders		**56.5**		63.5
Operating expenses		**675.9**		688.4
Total expenses		**2,007.7**		2,058.5
Income before income taxes		**256.3**		130.1
Income taxes		**52.7**		7.5
Net income		**203.6**		122.6
Net income attributable to noncontrolling interest		**4.6**		1.6
Net income attributable to Principal Financial Group, Inc.		**199.0**		121.0
Preferred stock dividends		**8.2**		8.2
Net income available to common stockholders	$	**190.8**	$	112.8
Earnings per common share				
Basic earnings per common share	$	**0.60**	$	0.43
Diluted earnings per common share	$	**0.59**	$	0.43

See accompanying notes.

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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 loss	Treasury stock	Noncontrolling interest	Total stockholders equity
					(in millions)				
Balances at January 1, 2009	$	$ 0.1	$ 3.9	$ 8,376.5	$ 3,722.5	$ (4,911.6)	$ (4,718.6)	$ 96.5	$ 2,569.3
Common stock issued				4.0					4.0
Stock-based compensation and additional related tax benefits				7.0					7.0
Treasury stock acquired, common							(3.0)		(3.0)
Dividends to preferred stockholders					(8.2)				(8.2)
Distributions to noncontrolling interest								(17.4)	(17.4)
Purchase of subsidiary shares from noncontrolling interest				(45.4)				(0.2)	(45.6)
Effects of reclassifying noncredit component of previously recognized impairment losses on fixed maturities, available-for-sale, net					9.9	(9.9)			
Comprehensive income:									
Net income					121.0			1.6	122.6
Net unrealized gains, net						79.9			79.9
Noncredit component of impairment losses on fixed maturities, available-for-sale, net						(32.6)			(32.6)
Foreign currency translation adjustment, net of related income taxes						18.1		(0.2)	17.9
Unrecognized postretirement benefit obligation, net of related income taxes						15.0			15.0
Comprehensive income									202.8
Balances at March 31, 2009	$	$ 0.1	$ 3.9	$ 8,342.1	$ 3,845.2	$ (4,841.1)	$ (4,721.6)	$ 80.3	$ 2,708.9
Balances at January 1, 2010	**$**	**$ 0.1**	**$ 4.5**	**$ 9,492.9**	**$ 4,160.7**	**$ (1,042.0)**	**$ (4,722.7)**	**$ 122.9**	**$ 8,016.4**
Common stock issued				**8.3**					**8.3**
Stock-based compensation and additional related tax benefits				**11.3**					**11.3**
Treasury stock acquired, common							**(1.7)**		**(1.7)**
Dividends to preferred stockholders					**(8.2)**				**(8.2)**
Distributions to noncontrolling interest								**(1.0)**	**(1.0)**
Contributions from noncontrolling interest								**5.9**	**5.9**

Effects of implementation of accounting change related to variable interest entities, net					(10.7)	10.7			
Comprehensive income:									
Net income					199.0			4.6	203.6
Net unrealized gains, net						449.1			449.1
Noncredit component of impairment losses on fixed maturities, available-for-sale, net						(3.0)			(3.0)
Foreign currency translation adjustment, net of related income taxes						(2.6)		0.2	(2.4)
Unrecognized postretirement benefit obligation, net of related income taxes						9.9			9.9
Comprehensive income									657.2
Balances at March 31, 2010	**$**	**$ 0.1**	**$ 4.5**	**$ 9,512.5**	**$ 4,340.8**	**$ (577.9)**	**$ (4,724.4)**	**$ 132.6**	**$ 8,688.2**

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

	For the three months ended March 31, 2010	2009
	(in millions)	
Operating activities		
Net income	**$ 203.6**	$ 122.6
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred policy acquisition costs	**72.8**	85.1
Additions to deferred policy acquisition costs	**(123.8)**	(143.8)
Accrued investment income	**(32.1)**	(33.9)
Net cash flows for trading securities	**(148.8)**	74.6
Premiums due and other receivables	**(12.0)**	(42.9)
Contractholder and policyholder liabilities and dividends	**255.9**	281.9
Current and deferred income taxes	**37.6**	8.2
Net realized capital losses	**45.5**	63.3
Depreciation and amortization expense	**29.9**	33.3
Mortgage loans held for sale, acquired or originated	**(15.9)**	(10.3)
Mortgage loans held for sale, sold or repaid, net of gain	**13.7**	12.2
Real estate acquired through operating activities		(16.3)
Real estate sold through operating activities	**3.1**	
Stock-based compensation	**10.7**	5.3
Other	**313.0**	510.6
Net adjustments	**449.6**	827.3
Net cash provided by operating activities	**653.2**	949.9
Investing activities		
Available-for-sale securities:		
Purchases	**(2,228.5)**	(1,771.9)
Sales	**707.2**	765.8
Maturities	**828.5**	892.7
Mortgage loans acquired or originated	**(219.1)**	(92.9)
Mortgage loans sold or repaid	**451.5**	283.5
Real estate acquired	**(9.7)**	(3.7)
Real estate sold		0.4
Net purchases of property and equipment	**(4.2)**	(13.2)
Purchases of interest in subsidiaries, net of cash acquired		(34.2)
Net change in other investments	**12.3**	(13.1)
Net cash provided by (used in) investing activities	**$ (462.0)**	$ 13.4

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Principal Financial Group, Inc.

Consolidated Statements of Cash Flows (continued)

(Unaudited)

	For the three months ended March 31, 2010	2009
	(in millions)	
Financing activities		
Issuance of common stock	**$ 8.3**	$ 4.0
Acquisition of treasury stock	**(1.7)**	(3.0)
Proceeds from financing element derivatives	**16.6**	36.8
Payments for financing element derivatives	**(13.2)**	(25.0)
Excess tax benefits from share-based payment arrangements	**0.4**	0.1
Dividends to preferred stockholders	**(8.2)**	(8.2)
Issuance of long-term debt	**0.2**	
Principal repayments of long-term debt	**(3.4)**	(4.9)
Net proceeds from short-term borrowings	**31.2**	27.7
Investment contract deposits	**1,051.0**	1,886.2
Investment contract withdrawals	**(1,920.7)**	(2,819.4)
Net increase in banking operation deposits	**38.7**	35.5
Other	**(1.1)**	(1.5)
Net cash used in financing activities	**(801.9)**	(871.7)
Net increase (decrease) in cash and cash equivalents	**(610.7)**	91.6
Cash and cash equivalents at beginning of period	**2,240.4**	2,608.0
Cash and cash equivalents at end of period	**$ 1,629.7**	$ 2,699.6

See accompanying notes.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements

March 31, 2010

(Unaudited)

1. Nature of Operations and Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements of Principal Financial Group, Inc. (PFG), its majority-owned subsidiaries and its consolidated variable interest entities (VIEs), have been prepared in conformity with accounting principles generally accepted in the U.S. (U.S. GAAP) for interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2010, are not necessarily indicative of the results that may be expected for the year ended December 31, 2010. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2009, included in our Form 10-K for the year ended December 31, 2009, filed with the United States Securities and Exchange Commission (SEC). The accompanying consolidated statement of financial position as of December 31, 2009, has been derived from the audited consolidated statement of financial position but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Recent Accounting Pronouncements

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

In March 2010, the FASB issued authoritative guidance that amends and clarifies the guidance on evaluation of credit derivatives embedded in beneficial interests in securitized financial assets, including asset-backed securities, credit-linked notes, collateralized loan obligations and collateralized debt obligations (CDOs). This guidance eliminates the scope exception for bifurcation of embedded credit derivatives in interests in securitized financial assets, unless they are created solely by subordination of one financial instrument to another. This guidance will be effective for us on July 1, 2010, and we are currently assessing the impact it will have on our consolidated financial statements.

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

In June 2009, the FASB issued authoritative guidance to improve the relevance, representational faithfulness and comparability of the information that a reporting entity provides in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor s continuing involvement in transferred financial assets. The most significant change is the elimination of the concept of a qualifying special-purpose entity (QSPE). Therefore, former QSPEs, as defined under previous accounting standards, should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. This guidance was effective for us on January 1, 2010, and did not have a material impact on our consolidated financial statements.

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Principal Financial Group, Inc.
Notes to Consolidated Financial Statements (continued)
March 31, 2010
(Unaudited)

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

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

Separate Accounts

At March 31, 2010 and December 31, 2009, the separate accounts include a separate account valued at $221.2 million and $191.5 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. On January 1, 2010, we adopted authoritative guidance that changed the method of determining the primary beneficiary of a VIE. Prior to January 1, 2010, the primary beneficiary was the enterprise who absorbed the majority of the entity s expected losses, received a majority of the expected residual returns or both. The new guidance identifies the primary beneficiary of a VIE as the enterprise with (1) the power to direct the activities of a VIE that most significantly impact the 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. Due to the implementation of this guidance, certain previously unconsolidated VIEs were consolidated and certain previously consolidated VIEs were deconsolidated. See further discussion of the adoption in Note 1, Nature of Operations and Significant Accounting Policies.

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. As our interest-only certificates are exposed to the majority of the risk of loss due to interest rate risk, we determined we were the primary beneficiary prior to January 1, 2010. Beginning January 1, 2010, we determined we remain the primary beneficiary as a result of our contribution of securities into the trusts.

Principal Financial Group, Inc.
Notes to Consolidated Financial Statements (continued)
March 31, 2010
(Unaudited)

2. Variable Interest Entities (continued)

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

Prior to January 1, 2010, we determined we were the primary beneficiary of a certain number of these entities due to the nature of our direct investment in the VIEs. As of December 31, 2009, we consolidated five collateralized private investment vehicles with assets of $135.7 million. Upon adoption of the new accounting guidance as of January 1, 2010, we determined we were no longer the primary beneficiary of three of these entities with assets of $65.4 million. For these three entities, we do not control the decisions affecting the economic performance of the entities and we were not involved with the design of the entities. We continue to hold $53.6 million of investments in these entities classified on the consolidated statements of financial position as fixed maturities, available-for-sale or fixed maturities, trading. We also determined we are the primary beneficiary of two additional collateralized private investment vehicles. For all the collateralized structures consolidated as of March 31, 2010, we are the primary beneficiary because we act as the investment manager of the underlying portfolio and we have an ownership interest.

Commercial Mortgage-Backed Securities. In September 2000, we sold commercial mortgage loans to a real estate mortgage investment conduit trust. The trust issued various commercial mortgage-backed securities (CMBS) certificates using the cash flows of the underlying commercial mortgages it purchased. Prior to January 1, 2010, this entity was scoped out of the consolidation guidance as a QSPE. Based on the new accounting guidance, the previous scope exception for QSPEs no longer exists and this entity is now a VIE due to the entity having insufficient equity to sustain itself. We have determined we are the primary beneficiary as we retained the special servicing role for the assets within the trust as well as the ownership of the bond class which controls the unilateral kick out rights of the special servicer.

Hedge Funds. We are a general partner with an insignificant equity ownership in various hedge funds. These entities are deemed VIEs due to the equity owners not having decision-making ability. Before January 1, 2010, we consolidated these VIEs due to our related parties ownership. Beginning January 1, 2010, we continue to consolidate these entities due to our control through our management relationship, related party ownership and our fee structure in certain of these funds. These entities contain various fixed maturity securities held as available-for-sale and trading and equity securities held as trading.

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 as of March 31, 2010, are as follows:

	Grantor trusts	Collateralized private investment vehicles	CMBS (in millions)	Hedge funds (2)	Total
March 31, 2010					
Fixed maturities, available-for-sale	$ **248.4**	$ **14.4**	$	$	$ **262.8**
Fixed maturities, trading		**164.7**			**164.7**
Equity securities, trading				**93.6**	**93.6**
Other investments			**117.4**		**117.4**
Cash and cash equivalents		**55.0**		**51.8**	**106.8**
Accrued investment income	**0.6**	**0.1**	**0.9**		**1.6**
Premiums due and other receivables		**1.5**		**13.3**	**14.8**
Total assets	$ **249.0**	$ **235.7**	$ **118.3**	$ **158.7**	$ **761.7**
Deferred income taxes	$ **2.7**	$	$	$	$ **2.7**
Other liabilities (1)	**113.6**	**159.8**	**102.5**	**39.3**	**415.2**
Total liabilities	$ **116.3**	$ **159.8**	$ **102.5**	$ **39.3**	$ **417.9**

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Principal Financial Group, Inc.
Notes to Consolidated Financial Statements (continued)
March 31, 2010
(Unaudited)

2. Variable Interest Entities (continued)

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

(2) The consolidated statements of financial position included a $118.7 million noncontrolling interest for hedge funds.

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

Unconsolidated Variable Interest Entities

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

VIEs include CMBS, residential mortgage-backed securities, and asset-backed securities. All of these entities were deemed VIEs upon the removal of the QSPE scope exception because the equity within these entities is insufficient to sustain them. We currently are not the primary beneficiary in any of the entities within these categories of investments. This determination was based primarily on the fact we do not own the class of security, which controls the unilateral right to replace the special servicer or equivalent function.

As previously discussed, we invest in several types of collateralized private investment vehicles, which are VIEs. These include cash and synthetic structures that we do not manage. We are currently 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. Prior to January 1, 2010, we had performed a quantitative analysis and concluded that although we held a significant variable interest in these entities we were not the primary beneficiary due to lack of majority of the risk of loss or because they were scoped out as a QSPE. Beginning January 1, 2010, we concluded we are not the primary beneficiary primarily because we do not control the economic performance of the entities and were not involved with the design of the entities.

The carrying value and maximum loss exposure for our unconsolidated VIEs as of March 31, 2010, are as follows:

	Asset carrying value	Maximum exposure to loss (1)
	(in millions)	
March 31, 2010		
Fixed maturities, available-for-sale:		
Corporate	**$ 393.2**	**$ 359.0**
Residential mortgage-backed securities	**3,030.5**	**2,933.0**
Commercial mortgage-backed securities	**3,782.1**	**4,855.1**
Collateralized debt obligations	**372.6**	**574.4**
Other debt obligations	**2,863.3**	**3,050.7**
Fixed maturities, trading:		
Residential mortgage-backed securities	**185.7**	**185.7**
Commercial mortgage-backed securities	**3.3**	**3.3**
Collateralized debt obligations	**9.8**	**9.8**
Other debt obligations	**184.8**	**184.8**

(1) Our risk of loss is limited to our initial investment measured at amortized cost.

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3. Investments

Fixed Maturities and Equity Securities

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

The cost of fixed maturity securities 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.

The amortized cost, gross unrealized gains and losses, other-than-temporary impairments in OCI and fair value of fixed maturities and equity securities available-for-sale as of March 31, 2010 and December 31, 2009, are summarized as follows:

	Amortized cost	Gross unrealized gains	Gross unrealized losses (in millions)	Other-than-temporary impairments in OCI	Fair value
March 31, 2010					
Fixed maturities, available-for-sale:					
U.S. government and agencies	$ **562.8**	$ **13.2**	$	$	$ **576.0**
Non-U.S. governments	**758.3**	**114.2**	**0.4**		**872.1**
States and political subdivisions	**2,189.9**	**61.5**	**11.2**		**2,240.2**
Corporate	**33,255.6**	**1,522.8**	**696.5**	**53.3**	**34,028.6**
Residential mortgage-backed securities	**2,933.0**	**98.7**	**1.2**		**3,030.5**
	4,855.1	**55.7**	**1,021.0**	**107.7**	**3,782.1**

Commercial mortgage-backed securities										
Collateralized debt obligations		**574.4**		**0.5**		**166.9**		**35.4**		**372.6**
Other debt obligations		**3,050.7**		**46.1**		**146.1**		**87.4**		**2,863.3**
Total fixed maturities, available-for-sale	**$**	**48,179.8**	**$**	**1,912.7**	**$**	**2,043.3**	**$**	**283.8**	**$**	**47,765.4**
Total equity securities, available-for-sale	**$**	**197.7**	**$**	**8.2**	**$**	**24.0**			**$**	**181.9**
December 31, 2009										
Fixed maturities, available-for-sale:										
U.S. government and agencies	$	550.1	$	9.1	$	0.5	$		$	558.7
Non-U.S. governments		741.5		114.8		1.4				854.9
States and political subdivisions		2,008.7		53.4		13.5				2,048.6
Corporate		32,767.0		1,296.8		1,075.0		58.0		32,930.8
Residential mortgage-backed securities		3,049.5		87.4		3.8				3,133.1
Commercial mortgage-backed securities		4,898.0		20.9		1,211.5		107.7		3,599.7
Collateralized debt obligations		607.5		1.8		200.7		39.0		369.6
Other debt obligations		2,994.1		34.6		229.8		73.7		2,725.2
Total fixed maturities, available-for-sale	$	47,616.4	$	1,618.8	$	2,736.2	$	278.4	$	46,220.6
Total equity securities, available-for-sale	$	231.1	$	17.2	$	34.3			$	214.0

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Principal Financial Group, Inc.
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3. Investments (continued)

The amortized cost and fair value of fixed maturities available-for-sale as of March 31, 2010, by contractual maturity, were as follows:

	Amortized cost	Fair value
	(in millions)	
Due in one year or less	$ 2,236.3	$ 2,292.3
Due after one year through five years	13,472.4	14,000.4
Due after five years through ten years	9,584.6	9,863.2
Due after ten years	11,473.3	11,561.0
	36,766.6	37,716.9
Mortgage-backed and other asset-backed securities	11,413.2	10,048.5
Total	$ 48,179.8	$ 47,765.4

Actual maturities may differ because issuers 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 general, in addition to realized capital gains and losses on investment sales and periodic settlements on derivatives not designated as hedges, gains and losses related to other-than-temporary impairments, certain trading securities, 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 and impairments of real estate held for investment are reported as net realized capital gains (losses). 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, are reported as net investment income and are excluded from net realized capital gains (losses). We also have trading securities portfolios that support investment strategies that involve the active and frequent purchase and sale of fixed maturity securities for which the mark-to-market adjustments are reported as net investment income and are excluded from net realized capital gains (losses). The major components of net realized capital gains (losses) on investments are summarized as follows:

	For the three months ended March 31, 2010	2009
	(in millions)	
Fixed maturities, available-for-sale:		
Gross gains	$ 19.0	$ 49.4
Gross losses	(93.6)	(156.8)

Portion of other-than-temporary impairment losses recognized in OCI		**5.4**		50.6
Hedging, net		**46.7**		(53.4)
Fixed maturities, trading		**10.5**		23.6
Equity securities, available-for-sale:				
Gross gains		**7.5**		6.8
Gross losses		**(1.5)**		(0.6)
Equity securities, trading		**7.9**		(9.6)
Mortgage loans		**(26.0)**		(35.5)
Derivatives		**(49.7)**		68.2
Other		**28.3**		(6.0)
Net realized capital losses	**$**	**(45.5)**	$	(63.3)

Proceeds from sales of investments (excluding call and maturity proceeds) in fixed maturities, available-for-sale were $0.6 billion and $0.9 billion for the three months ended March 31, 2010 and 2009, respectively.

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Principal Financial Group, Inc.
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3. Investments (continued)

Other-Than-Temporary Impairments

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

Each reporting period, all securities are reviewed to determine whether an other-than-temporary decline in value exists and whether losses should be recognized. We consider relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) for fixed maturity securities, 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 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. The way in which impairment losses on fixed maturity securities 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, less any current period credit loss, we recognize an other-than-temporary impairment in net income for the difference between amortized cost and fair value. If we do not expect to recover the amortized cost basis, we do not plan to sell the security and if it is not more likely than not that we would be required to sell a security before the recovery of its amortized cost, less any current period credit loss, 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.

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 asset-backed securities cash flow estimates are based on bond 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 bond 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.

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

	For the three months ended March 31, 2010	2009
	(in millions)	
Fixed maturities, available-for-sale	**$ (88.6)**	$ (152.7)
Equity securities, available-for-sale	**4.0**	6.1
Total other-than-temporary impairment losses, net of recoveries from the sale of previously impaired securities	**$ (84.6)**	$ (146.6)

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Principal Financial Group, Inc.
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3. Investments (continued)

The other-than-temporary impairments on fixed maturity securities for which an amount related to credit losses was recognized in net realized capital gains (losses) and an amount related to noncredit losses was recognized in OCI is summarized as follows:

	For the three months ended March 31, 2010		2009	
	(in millions)			
Total other-than-temporary impairments on fixed maturity securities for which an amount related to noncredit losses was recognized in OCI (1)	**$**	**(63.8)**	$	(99.2)
Noncredit loss recognized in OCI		**5.4**		50.6
Credit loss impairment recognized in net realized capital losses	**$**	**(58.4)**	$	(48.6)

(1) For the three months ended March 31, 2010 and 2009, total other-than-temporary impairment losses on available-for-sale securities reported in the consolidated statements of operations also include $24.8 million and $53.5 million of impairment losses, net of recoveries from the sale of previously impaired securities, on fixed maturity securities and $4.0 million and $6.1 million of net recoveries from the sale of previously impaired securities, on equity securities for which total impairment losses are recognized in net income, respectively.

The following table provides a rollforward of credit losses on fixed maturity securities recognized in net income (bifurcated credit losses) for which a portion of an other-than-temporary impairment was recognized in OCI. The purpose of the table is to provide detail of (1) additions to the bifurcated credit loss amounts recognized for the period and (2) decrements for previously recognized bifurcated credit losses where the loss is no longer bifurcated and/or there has been a positive change in expected cash flows or accretion of the bifurcated credit loss amount.

	For the three months ended March 31, 2010		2009	
	(in millions)			
Beginning balance	**$**	**(204.7)**	$	(18.5)
Credit losses for which an other-than-temporary impairment was not previously recognized		**(54.8)**		(48.0)
Credit losses for which an other-than-temporary impairment was previously recognized		**(22.2)**		(0.6)
Reduction for credit losses previously recognized on securities now sold or intended to be sold		**18.6**		
Reduction for positive changes in cash flows expected to be collected and amortization (1)		**0.4**		
Ending balance	**$**	**(262.7)**	$	(67.1)

(1) Amounts are recognized in net investment income.

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3. Investments (continued)

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, as of March 31, 2010, 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	Greater than or equal to twelve months	Total
	Carrying value		