PRINCIPAL FINANCIAL GROUP INC
Form 10-Q
November 04, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2009

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 October 28, 2009, was 318,943,811.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Principal Financial Group, Inc.
Consolidated Statements of Financial Position

	September 30, 2009 (Unaudited)	December 31, 2008
	(in millions)	
Assets		
Fixed maturities, available-for-sale	**$ 45,683.6**	$ 40,117.2
Fixed maturities, trading	**1,029.8**	843.4
Equity securities, available-for-sale	**218.4**	242.7
Equity securities, trading	**178.8**	158.0
Mortgage loans	**12,018.7**	13,113.6
Real estate	**1,024.9**	919.4
Policy loans	**899.6**	896.4
Other investments	**2,553.2**	2,816.6
Total investments	**63,607.0**	59,107.3
Cash and cash equivalents	**3,241.2**	2,608.0
Accrued investment income	**742.7**	750.7
Premiums due and other receivables	**1,135.8**	988.1
Deferred policy acquisition costs	**3,591.4**	4,153.0
Property and equipment	**496.8**	518.2
Goodwill	**382.6**	375.5
Other intangibles	**864.9**	925.3
Separate account assets	**61,518.7**	55,142.6
Other assets	**1,798.4**	3,613.7
Total assets	**$ 137,379.5**	$ 128,182.4
Liabilities		
Contractholder funds	**$ 40,951.7**	$ 43,086.6
Future policy benefits and claims	**18,938.0**	18,494.2
Other policyholder funds	**564.4**	536.2
Short-term debt	**107.1**	500.9
Long-term debt	**1,586.1**	1,290.5
Income taxes currently payable	**2.0**	1.9
Deferred income taxes	**116.1**	102.8
Separate account liabilities	**61,518.7**	55,142.6
Other liabilities	**5,988.7**	6,457.4
Total liabilities	**129,772.8**	125,613.1
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 2009 and 2008		
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 2009 and 2008	**0.1**	0.1
Common stock, par value $.01 per share - 2,500.0 million shares authorized, 446.9 million and 387.0 million shares issued, and 318.9 million and 259.3 million shares outstanding in 2009 and 2008	**4.5**	3.9
Additional paid-in capital	**9,480.7**	8,376.5
Retained earnings	**4,180.2**	3,722.5
Accumulated other comprehensive loss	**(1,434.1)**	(4,911.6)
Treasury stock, at cost (128.0 million and 127.7 million shares in 2009 and 2008, respectively)	**(4,722.7)**	(4,718.6)
Total stockholders equity attributable to Principal Financial Group, Inc.	**7,508.7**	2,472.8
Noncontrolling interest	**98.0**	96.5
Total stockholders equity	**7,606.7**	2,569.3
Total liabilities and stockholders equity	**$ 137,379.5**	$ 128,182.4

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Operations

(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2009	2008	2009	2008
	(in millions, except per share data)			
Revenues				
Premiums and other considerations	**$ 932.9**	$ 1,049.7	**$ 2,820.5**	$ 3,258.9
Fees and other revenues	**550.7**	599.0	**1,539.4**	1,834.9
Net investment income	**853.3**	1,079.7	**2,541.9**	3,030.9
Net realized capital gains (losses), excluding impairment losses on available-for-sale securities	**50.6**	(20.9)	**62.5**	(145.0)
Total other-than-temporary impairment losses on available-for-sale securities	**(162.5)**	(209.7)	**(510.0)**	(323.1)
Portion of impairment losses on fixed maturities, available-for-sale recognized in other comprehensive income	**45.3**		**162.4**	
Net impairment losses on available-for-sale securities	**(117.2)**	(209.7)	**(347.6)**	(323.1)
Net realized capital losses	**(66.6)**	(230.6)	**(285.1)**	(468.1)
Total revenues	**2,270.3**	2,497.8	**6,616.7**	7,656.6
Expenses				
Benefits, claims and settlement expenses	**1,317.1**	1,597.2	**3,958.0**	4,703.2
Dividends to policyholders	**61.9**	70.4	**188.3**	210.2
Operating expenses	**643.0**	723.7	**1,894.1**	2,217.0
Total expenses	**2,022.0**	2,391.3	**6,040.4**	7,130.4
Income before income taxes	**248.3**	106.5	**576.3**	526.2
Income taxes (benefits)	**44.1**	(2.2)	**85.5**	56.8
Net income	**204.2**	108.7	**490.8**	469.4
Net income attributable to noncontrolling interest	**11.3**	10.4	**18.3**	12.1
Net income attributable to Principal Financial Group, Inc.	**192.9**	98.3	**472.5**	457.3
Preferred stock dividends	**8.2**	8.2	**24.7**	24.7
Net income available to common stockholders	**$ 184.7**	$ 90.1	**$ 447.8**	$ 432.6
Earnings per common share				
Basic earnings per common share	**$ 0.58**	$ 0.35	**$ 1.54**	$ 1.67
Diluted earnings per common share	**$ 0.57**	$ 0.35	**$ 1.54**	$ 1.66

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 income (loss)	Treasury stock	Noncontrolling interest	Total stockholders equity
					(in millions)				
Balances at January 1, 2008	$	$ 0.1	$ 3.9	$ 8,295.4	$ 3,414.3	$ 420.2	$ (4,712.2)	$ 97.6	$ 7,519.3
Common stock issued				31.5					31.5
Capital transactions of equity method investee, net of related income taxes				0.3					0.3
Stock-based compensation and additional related tax benefits				39.5					39.5
Treasury stock acquired, common							(6.4)		(6.4)
Dividends to preferred stockholders					(24.7)				(24.7)
Dividends to noncontrolling interest								(12.8)	(12.8)
Capital received from noncontrolling interest								3.2	3.2
Effects of changing post-retirement benefit plan measurement date, net of related income taxes					0.9	(2.0)			(1.1)
Comprehensive loss:									
Net income					457.3			12.1	469.4
Net unrealized losses, net						(2,282.8)			(2,282.8)
Foreign currency translation adjustment, net of related income taxes						(16.7)		(1.1)	(17.8)
Unrecognized post-retirement benefit obligation, net of related income taxes						(6.0)			(6.0)
Comprehensive loss									(1,837.2)
Balances at September 30, 2008	$	$ 0.1	$ 3.9	$ 8,366.7	$ 3,847.8	$ (1,887.3)	$ (4,718.6)	$ 99.0	$ 5,711.6
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			**0.6**	**1,122.4**					**1,123.0**
Stock-based compensation and additional related tax benefits				**27.7**					**27.7**
Treasury stock acquired, common							**(4.1)**		**(4.1)**
Dividends to preferred stockholders					**(24.7)**				**(24.7)**
Dividends to noncontrolling interest								**(5.4)**	**(5.4)**
Purchase of subsidiary shares from noncontrolling interest				**(45.9)**				**0.2**	**(45.7)**
Capital paid to noncontrolling interest								**(11.7)**	**(11.7)**
Effects of reclassifying noncredit component of previously recognized impairment					**9.9**	**(9.9)**			

losses on fixed maturities, available-for-sale, net									
Comprehensive income:									
Net income					**472.5**			**18.3**	**490.8**
Net unrealized gains, net						**3,426.2**			**3,426.2**
Noncredit component of impairment losses on fixed maturities, available-for-sale, net						**(99.0)**			**(99.0)**
Foreign currency translation adjustment, net of related income taxes						**115.3**		**0.1**	**115.4**
Unrecognized post-retirement benefit obligation, net of related income taxes						**44.9**			**44.9**
Comprehensive income									**3,978.3**
Balances at September 30, 2009	**$**	**$ 0.1**	**$ 4.5**	**$ 9,480.7**	**$ 4,180.2**	**$ (1,434.1)**	**$ (4,722.7)**	**$ 98.0**	**$ 7,606.7**

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

	For the nine months ended September 30,	
	2009	2008
	(in millions)	
Operating activities		
Net income	**$ 490.8**	$ 469.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred policy acquisition costs	**70.4**	212.6
Additions to deferred policy acquisition costs	**(361.0)**	(540.1)
Accrued investment income	**8.0**	(32.8)
Net cash flows from trading securities	**(101.0)**	(451.9)
Premiums due and other receivables	**(106.1)**	10.0
Contractholder and policyholder liabilities and dividends	**1,189.6**	1,747.0
Current and deferred income taxes (benefits)	**128.0**	(93.5)
Net realized capital losses	**285.1**	468.1
Depreciation and amortization expense	**104.4**	105.4
Mortgage loans held for sale, acquired or originated	**(41.7)**	(56.4)
Mortgage loans held for sale, sold or repaid, net of gain	**49.4**	52.1
Real estate acquired through operating activities	**(25.1)**	(50.7)
Real estate sold through operating activities	**3.2**	14.6
Stock-based compensation	**26.9**	32.8
Other	**73.5**	(19.4)
Net adjustments	**1,303.6**	1,397.8
Net cash provided by operating activities	**1,794.4**	1,867.2
Investing activities		
Available-for-sale securities:		
Purchases	**(6,600.7)**	(6,205.6)
Sales	**3,770.5**	524.5
Maturities	**3,146.0**	2,483.7
Mortgage loans acquired or originated	**(271.8)**	(1,682.3)
Mortgage loans sold or repaid	**1,247.2**	1,041.8
Real estate acquired	**(50.2)**	(20.6)
Real estate sold	**22.1**	68.7
Net purchases of property and equipment	**(20.6)**	(83.3)
Purchases of interest in subsidiaries, net of cash acquired	**(45.7)**	(20.3)
Net change in other investments	**(40.6)**	(124.9)
Net cash provided by (used in) investing activities	**$ 1,156.2**	$ (4,018.3)

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Consolidated Statements of Cash Flows (continued)

(Unaudited)

	For the nine months ended, September 30,	
	2009	2008
	(in millions)	
Financing activities		
Issuance of common stock	**$ 1,123.0**	$ 31.5
Acquisition of treasury stock	**(4.1)**	(6.4)
Proceeds from financing element derivatives	**121.3**	130.6
Payments for financing element derivatives	**(57.7)**	(91.3)
Excess tax benefits from share-based payment arrangements	**0.2**	2.8
Dividends to preferred stockholders	**(24.7)**	(24.7)
Issuance of long-term debt	**745.1**	6.4
Principal repayments of long-term debt	**(465.9)**	(17.3)
Net proceeds (repayments) of short-term borrowings	**(397.4)**	63.9
Investment contract deposits	**3,438.2**	9,852.4
Investment contract withdrawals	**(6,871.1)**	(7,160.6)
Net increase in banking operation deposits	**80.2**	293.0
Other	**(4.5)**	(4.6)
Net cash provided by (used in) financing activities	**(2,317.4)**	3,075.7
Net increase in cash and cash equivalents	**633.2**	924.6
Cash and cash equivalents at beginning of period	**2,608.0**	1,344.4
Cash and cash equivalents at end of period	**$ 3,241.2**	$ 2,269.0

See accompanying notes.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements

September 30, 2009

(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 nine months ended September 30, 2009, are not necessarily indicative of the results that may be expected for the year ended December 31, 2009. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2008, included in our Form 10-K for the year ended December 31, 2008, filed with the United States Securities and Exchange Commission (SEC). The accompanying consolidated statement of financial position as of December 31, 2008, 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.

We have evaluated subsequent events through November 4, 2009, which was the date our consolidated financial statements were issued.

Reclassifications have been made to prior period financial statements to conform to the September 30, 2009, presentation. See Recent Accounting Pronouncements for impact of new accounting guidance on prior period financial statements.

Recent Accounting Pronouncements

On September 30, 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-12, Fair Value Measurements and Disclosures (Topic 820), *Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)* (ASU 2009-12). ASU 2009-12 provides guidance on measuring the fair value of certain alternative investments, and amends Accounting Standards Codification (ASC) Topic 820 to offer investors a practical means for measuring the fair value of investments in certain entities that calculate net asset value per share. ASU 2009-12 is effective for periods ending after December 15, 2009. We are evaluating the impact this guidance will have on our consolidated financial statements.

On August 28, 2009, the FASB issued ASU No. 2009-05, Fair Value Measurements and Disclosures (Topic 820), *Measuring Liabilities at Fair Value* (ASU 2009-05), to provide additional guidance on measuring the fair value of liabilities. ASU 2009-05 clarifies that the quoted price for the identical liability, when traded as an asset in an active market, is also a Level 1 measurement for that liability when no adjustment to the quoted price is required. In the absence of a quoted price in an active market, an entity must use one or more of the following valuation techniques to estimate fair value: (1) a valuation technique that uses a quoted price: (a) of an identical liability when traded as an asset or (b) of a similar liability when traded as an asset; (2) another valuation technique such as (a) a present value technique or (b) a technique based on the amount an entity would pay to transfer the identical liability or would receive to enter into an identical liability. ASU 2009-05 will be effective for us for fourth quarter 2009 reporting and is not expected to have a material impact on our consolidated financial statements.

On June 30, 2009, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 168, *The FASB Accounting Standards CodificationTM and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162*, which was subsequently incorporated into ASC Subtopic 105-10, *Generally Accepted Accounting Principles Overall.* This guidance replaces *The Hierarchy of Generally Accepted Accounting Principles* and establishes the *FASB Accounting Standards CodificationTM* (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. GAAP. Rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority. This guidance was effective for financial statements issued for interim and annual periods ending after September 15, 2009, 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)
September 30, 2009
(Unaudited)

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

On June 12, 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (SFAS 166). The objective of SFAS 166 is 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. Therefore, formerly qualifying special-purpose entities (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. SFAS 166 will be effective for us on January 1, 2010. Earlier adoption is prohibited. We are evaluating the impact this guidance will have on our consolidated financial statements.

Also on June 12, 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* (SFAS 167). SFAS 167 amends FASB Interpretation No. 46(R), to require 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 that has (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 that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. SFAS 167 requires ongoing reassessments of whether an enterprise is the primary beneficiary of a VIE. In addition, SFAS 167 requires enhanced 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. SFAS 167 will be effective for us on January 1, 2010. Earlier adoption is prohibited. We are evaluating the impact this guidance will have on our consolidated financial statements.

On April 9, 2009, the FASB issued FASB Staff Position (FSP) FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2), which was subsequently incorporated into ASC Subtopic 320-10, *Investments Debt and Equity Securities Overall*. This new guidance relates to the recognition and presentation of an other-than-temporary impairment (OTTI) and requires additional disclosures. The recognition provisions apply only to debt securities classified as available-for-sale and held-to-maturity, while the presentation and disclosure requirements apply to both debt and equity securities. An impaired debt security will be considered other-than-temporarily impaired if a holder has the intent to sell, or it more likely than not will be required to sell prior to recovery of the amortized cost. If a holder of a debt security does not expect recovery of the entire cost basis, even if there is no intention to sell the security, it will be considered an OTTI as well. This guidance also changes how an entity recognizes an OTTI for a debt security by separating the loss between the amount representing the credit loss and the amount relating to other factors, if a holder does not have the intent to sell or it more likely than not will not be required to sell prior to recovery of the amortized cost less any current period credit loss. Credit losses will be recognized in net income and losses relating to other factors will be recognized in other comprehensive income (OCI). If the holder has the intent to sell or it more likely than not will be required to sell before its recovery of amortized cost less any current period credit loss, the entire OTTI will continue to be recognized in net income. Furthermore, this guidance requires a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption with a corresponding adjustment to accumulated OCI. We adopted this guidance effective January 1, 2009. The cumulative change in accounting principle from adopting this guidance resulted in a net $9.9 million increase to retained earnings and a corresponding decrease to accumulated OCI. The required disclosures have been included in our consolidated financial statements.

On April 9, 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which was subsequently incorporated into ASC Subtopic 820-10, *Fair Value Measurements and Disclosures - Overall*. This guidance provides additional information on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity for the asset or liability and clarifies that the use of multiple valuation techniques may be appropriate. It also provides additional guidance on circumstances that may indicate a transaction is not orderly. Further, it requires additional disclosures about fair value measurements in annual and interim reporting periods. We adopted this guidance effective January 1, 2009, and it did not have a material impact on our consolidated financial statements. See Note 9, Fair Value of Financial Instruments, for further details.

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Principal Financial Group, Inc.
Notes to Consolidated Financial Statements (continued)
September 30, 2009
(Unaudited)

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

Also on April 9, 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments*, which was subsequently incorporated into ASC Subtopic 825-10, *Financial Instruments Overall*. This guidance extends the annual disclosure requirements of carrying value and estimated fair value of financial instruments to interim financial statements of public companies. We adopted this guidance effective April 1, 2009. The required disclosures have been included in Note 9, Fair Value of Financial Instruments.

On March 19, 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*, which was subsequently incorporated into ASC Subtopic 815-10, *Derivatives and Hedging Overall*. This guidance requires (1) qualitative disclosures about objectives and strategies for using derivatives, (2) quantitative disclosures about fair value amounts of gains and losses on derivative instruments and related hedged items and (3) disclosures about credit-risk-related contingent features in derivative instruments. The disclosures are intended to provide users of financial statements with an enhanced understanding of how and why derivative instruments are used, how they are accounted for and the financial statement impacts. We adopted these changes on January 1, 2009. See Note 3, Derivative Financial Instruments, for further details.

On December 4, 2007, the FASB issued SFAS No. 141(R), *Business Combinations*, which was subsequently incorporated into ASC Subtopic 805-10, *Business Combinations-Overall*. Among the changes, the standard requires that the acquiring entity in a business combination establish the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed, including any noncontrolling interests, and requires the acquirer to disclose additional information needed to more comprehensively evaluate and understand the nature and financial effect of the business combination. In addition, direct acquisition costs are to be expensed. We adopted this guidance on January 1, 2009, and all requirements are applied prospectively.

Also on December 4, 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an Amendment of Accounting Research Bulletin No. 51*, which was subsequently incorporated into ASC Subtopic 815-10, *Consolidation-Overall*. The following changes to noncontrolling interests were mandated as part of this new guidance: (1) Noncontrolling interests are to be treated as a separate component of equity, rather than as a liability or other item outside of equity. (2) Net income includes the total income of all consolidated subsidiaries, with separate disclosures on the face of the statement of operations of the income attributable to controlling and noncontrolling interests. Previously, net income attributable to the noncontrolling interest was reported as an operating expense in arriving at consolidated net income. (3) This guidance revises the accounting requirements for changes in a parent s ownership interest when the parent retains control and for changes in a parent s ownership interest that results in deconsolidation. We adopted this guidance on January 1, 2009. Presentation and disclosure requirements have been applied retrospectively for all periods presented. All other requirements should be applied prospectively. Certain separate account arrangements involve ownership of mutual funds to support the investment objective of the separate account. It is possible that, through a separate account arrangement, greater than 50% of the mutual fund shares could be owned. The accounting guidance for this circumstance is not well defined, but we, like many other insurers, do not consolidate the mutual fund as we believe the arrangement qualifies for the exemption afforded investment companies. In January 2009, the FASB asked the Emerging Issues Task Force (EITF) to consider a topic entitled Consideration of an Insurer s Accounting for Majority Owned Investments When the Ownership is through a Separate Account. On September 30, 2009, the FASB issued proposed ASU Financial Services Insurance (Topic 944), *Consideration of an Insurer s Accounting for Majority-Owned Investments When Ownership is Through a Separate Account*. The comment period for this proposed ASU ends on October 26, 2009, and while the final outcome is uncertain, the guidance as exposed supports our position.

Separate Accounts

As of September 30, 2009, and December 31, 2008, the separate accounts include a separate account valued at $222.2 million and $207.4 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. The separate account shares are recorded at fair value and are reported as separate account assets and separate account liabilities in the consolidated statements of financial position. 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.

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

2. Investments

Fixed Maturities and Equity Securities

Fixed maturity securities include bonds, mortgage-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 of Financial Instruments, 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 trading securities and hedged portions of available-for-sale securities in fair value hedging relationships are reflected in net income as net realized capital gains (losses).

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 maturity securities and equity securities is adjusted for other-than-temporary impairments recognized in net income. For loan-backed and structured securities, we recognize income using a constant effective yield based on currently anticipated prepayments using a tool that models the prepayment behavior of the underlying collateral based on the current interest rate environment.

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 September 30, 2009, are summarized as follows:

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Other-than-temporary impairments in OCI	Fair value
			(in millions)		
Fixed maturities, available-for-sale:					
U.S. government and agencies	$ 525.0	$ 11.1	$ 0.1	$	$ 536.0
Non-U.S. governments	725.6	101.2	2.0		824.8
States and political subdivisions	1,909.3	64.1	13.6		1,959.8
Corporate	32,625.3	1,410.1	1,405.0	21.3	32,609.1
Residential mortgage-backed securities	2,942.9	93.4	1.0		3,035.3
Commercial mortgage-backed securities	5,106.0	20.8	1,325.1	64.2	3,737.5
Collateralized debt obligations	607.0	1.0	242.1	40.3	325.6
Other debt obligations	2,954.2	36.0	280.6	54.1	2,655.5
Total fixed maturities, available-for-sale	$ 47,395.3	$ 1,737.7	$ 3,269.5	$ 179.9	$ 45,683.6
Total equity securities, available-for-sale	$ 255.4	$ 12.9	$ 49.9	$	$ 218.4

The amortized cost and fair value of fixed maturities available-for-sale as of September 30, 2009, by contractual maturity, were as follows:

	Amo−rtized− cost	Fair value
	(in millions)	
Due in one year or less	$ 1,606.5	$ 1,611.8
Due after one year through five years	13,265.5	13,598.9
Due after five years through ten years	9,300.1	9,341.0
Due after ten years	11,613.1	11,378.0
	35,785.2	35,929.7
Mortgage-backed and other asset-backed securities	11,610.1	9,753.9
Total	$ 47,395.3	$ 45,683.6

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.

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Principal Financial Group, Inc.
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(Unaudited)

2. Investments (continued)

Net Realized Capital Gains and Losses

Net realized capital gains and losses on sales of investments are determined on the basis of specific identification. In general, in addition to realized capital gains and losses on investment sales and periodic settlements on derivatives not designated as hedges, gains and losses related to other-than-temporary impairments, 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). The major components of net realized capital gains (losses) on investments are summarized as follows:

	For the three months ended September 30, 2009	For the nine months ended September 30, 2009
	(in millions)	
Fixed maturities, available-for-sale:		
Gross gains	$ 43.8	$ 107.4
Gross losses	(154.9)	(505.3)
Portion of impairment losses recognized in other comprehensive income	45.3	162.4
Hedging, net	68.3	(165.3)
Fixed maturities, trading	15.7	57.5
Equity securities, available-for-sale:		
Gross gains	12.6	25.1
Gross losses	(21.7)	(35.8)
Equity securities, trading	19.2	29.9
Mortgage loans	(39.2)	(115.8)
Derivatives	(64.5)	197.6
Other	8.8	(42.8)
Net realized capital losses	$ (66.6)	$ (285.1)

Proceeds from sales of investments (excluding call and maturity proceeds) in fixed maturities, available-for-sale were $2.1 billion and $3.7 billion for the three and nine months ended September 30, 2009, 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.

Every month, 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.

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

During first quarter 2009 we adopted FSP FAS 115-2, which changes the recognition and presentation of other-than-temporary impairments. See further discussion of the adoption in Note 1, Nature of Operations and Significant Accounting Policies. The recognition provisions within FSP FAS 115-2 apply only to debt securities classified as available-for-sale and held-to-maturity, while the presentation and disclosure requirements apply to both debt and equity securities.

Impairment losses on equity securities are recognized in net income. The way in which impairment losses on debt 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 debt 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, on fixed maturity securities were $153.0 million and $498.8 million for the three and nine months ended September 30, 2009, respectively. Total other-than-temporary impairment losses, net of recoveries from the sale of previously impaired securities, on equity securities were $9.5 million and $11.2 million for the three and nine months ended September 30, 2009, respectively.

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 September 30, 2009	For the nine months ended September 30, 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)	$	**(113.2)**	$	**(312.5)**
Noncredit loss recognized in OCI		**45.3**		**162.4**
Credit loss impairment recognized in net realized capital losses	$	**(67.9)**	$	**(150.1)**

(1) For the three and nine months ended September 30, 2009, total other-than-temporary impairment losses on available-for-sale securities reported in the consolidated statements of operations also include $39.8 million and $186.3 million, respectively, of impairment losses, net of recoveries from the sale of previously impaired securities, on fixed maturity securities and $9.5 million and $11.2 million, respectively, of impairment losses, net of recoveries from the sale of previously impaired securities, on equity securities for which total impairment losses are recognized in net income.

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.

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

	For the three months ended September 30, 2009	For the nine months ended September 30, 2009
	(in millions)	
Beginning balance	$ (100.6)	$ (18.5)
Credit losses for which an other-than-temporary impairment was not previously recognized	(55.2)	(127.5)
Credit losses for which an other-than-temporary impairment was previously recognized	(14.0)	(24.2)
Reduction for credit losses previously recognized on securities now sold or intended to be sold	1.3	1.6
Reduction for positive changes in cash flows expected to be collected and amortization (1)	0.7	0.8
Ending balance	$ (167.8)	$ (167.8)

(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, as of September 30, 2009, 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	Gross unrealized losses	Carrying value	Gross unrealized losses	Carrying value	Gross unrealized losses
			(in millions)			
Fixed maturities, available-for-sale:						
U.S. government and agencies	$ 5.0	$	$ 1.0	$ 0.1	$ 6.0	$ 0.1
Non-U.S. governments	7.1	0.1	35.6	1.9	42.7	2.0
States and political subdivisions	28.9	0.4	325.6	13.2	354.5	13.6
Corporate	1,073.1	60.6	9,737.5	1,365.7	10,810.6	1,426.3
	183.5	0.9	1.7	0.1	185.2	1.0

Residential mortgage-backed securities												
Commercial mortgage-backed securities		**332.9**		**20.4**		**2,607.1**		**1,368.9**		**2,940.0**		**1,389.3**
Collateralized debt obligations		**0.2**		**1.8**		**322.1**		**280.6**		**322.3**		**282.4**
Other debt obligations		**150.5**		**15.1**		**1,141.4**		**319.6**		**1,291.9**		**334.7**
Total fixed maturities, available-for-sale	**$**	**1,781.2**	**$**	**99.3**	**$**	**14,172.0**	**$**	**3,350.1**	**$**	**15,953.2**	**$**	**3,449.4**
Total equity securities, available-for-sale	**$**	**38.1**	**$**	**21.7**	**$**	**99.0**	**$**	**28.2**	**$**	**137.1**	**$**	**49.9**

Of the total amounts, Principal Life Insurance Company s (Principal Life) consolidated portfolio represented $15,176.7 million in available-for-sale fixed maturity securities with gross unrealized losses of $3,390.3 million. Principal Life s consolidated portfolio consists of fixed maturity securities where 82% are investment grade (rated AAA through BBB-) with an average price of 82 (carrying value/amortized cost) at September 30, 2009. Due to the credit disruption that began in the last half of 2007 and continued into 2009, which reduced liquidity and led to wider credit spreads, we saw an increase in unrealized losses in our securities portfolio. The unrealized losses were more pronounced in the Corporate sector and in structured products, such as commercial mortgage-backed securities, collateralized debt obligations and asset-backed securities (included in other debt obligations). During the second and third quarters of 2009, a narrowing of credit spreads and some improvement in liquidity resulted in a decrease in the unrealized losses in our securities portfolio relative to the period ended March 31, 2009.

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

For those securities that have been in a loss position for less than twelve months, Principal Life s consolidated portfolio holds 156 securities with a carrying value of $1,424.1 million and unrealized losses of $88.3 million reflecting an average price of 94 at September 30, 2009. Of this portfolio, 92% was investment grade (rated AAA through BBB-) at September 30, 2009, with associated unrealized losses of $67.1 million. The 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 have been in a continuous loss position greater than or equal to twelve months, Principal Life s consolidated portfolio holds 1,713 securities with a carrying value of $13,752.6 million and unrealized losses of $3,302.0 million. The average rating of this portfolio is A- with an average price of 81 at September 30, 2009. Of the $3,302.0 million in unrealized losses, the commercial mortgage-backed securities sector accounts for $1,368.8 million in unrealized losses with an average price of 66 and an average credit rating of AA-. The remaining unrealized losses consist primarily of $1,318.0 million within the Corporate sector at September 30, 2009. The average price of the Corporate sector is 88 and the average credit rating is BBB. The 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 it is not our intent to sell the fixed maturity available-for-sale securities with unrealized losses and it is 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 do not consider these investments to be other-than-temporarily impaired at September 30, 2009.

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

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

	September 30, 2009 (in millions)
Net unrealized losses on fixed maturities, available-for-sale (1)	$ (1,531.8)
Noncredit component of impairment losses on fixed maturities, available-for-sale	(162.4)
Net unrealized losses on equity securities, available-for-sale	(37.0)
Adjustments for assumed changes in amortization patterns	233.2

Adjustments for assumed changes in liability for policyholder benefits and claims		**(94.4)**
Net unrealized gains on derivative instruments		**47.7**
Net unrealized gains on equity method subsidiaries and noncontrolling interest adjustments		**184.3**
Provision for deferred income tax benefits		**516.8**
Effect of reclassifying noncredit component of previously recognized impairment losses on fixed maturities, available-for-sale, net		**(9.9)**
Net unrealized losses on available-for-sale securities and derivative instruments	**$**	**(853.5)**

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

Securities Posted as Collateral

We posted $911.6 million in fixed maturity securities as of September 30, 2009, to satisfy collateral requirements primarily associated with a reinsurance arrangement and our derivative credit support annex (collateral) agreements. In addition, we posted $1,822.0 million in commercial mortgage loans as of September 30, 2009, to satisfy collateral requirements associated with our obligation under funding agreements with the Federal Home Loan Bank of Des Moines.

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Principal Financial Group, Inc.
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3. 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. We do not buy, sell or hold these investments for trading purposes.

Types of Derivative Instruments

Interest Rate Contracts

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

Interest rate swaps are contracts in which we agree with other parties to exchange, at specified intervals, the difference between fixed rate and floating rate interest amounts based upon designated market rates or rate indices and an agreed upon notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. Cash is paid or received based on the terms of the swap. These transactions are entered into pursuant to master agreements that provide for a single net payment to be made by one counterparty at each due date. We use interest rate swaps primarily to more closely match the interest rate characteristics of assets and liabilities 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.

A swaption is an option to enter into an interest rate swap at a future date. We have written these options and received a premium in order to transform our callable liabilities into fixed term liabilities. 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.

A treasury lock is an agreement that allows the holder to lock in an interest rate. If the interest rate increases, the holder is entitled to receive a payment from the counterparty to the agreement equal to the present value of the difference in the current interest rate and the locked-in interest rate. If the interest rate decreases, the holder must pay the counterparty to the agreement an amount equal to the present value of the difference in the current interest rate and the locked-in interest rate. We have used treasury lock agreements to hedge against changes in the value of anticipated transactions and commitments.

Foreign Exchange Contracts

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from foreign currency-denominated funding agreements we issue, foreign currency-denominated fixed maturity securities we invest in and our investment in and net income of our international operations. We may use currency swaps and currency forwards to hedge foreign currency risk.

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Principal Financial Group, Inc.
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3. Derivative Financial Instruments (continued)

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, may also be fixed-to-floating rate or floating-to-fixed rate. These transactions are entered into pursuant to master agreements that provide for a single net payment to be made by one counterparty for payments made in the same currency at each due date. We use currency swaps to reduce market risks from changes in currency exchange rates with respect to investments or liabilities denominated in foreign currencies that we either hold or intend to acquire or sell.

Currency forwards are contracts in which we agree with other parties to deliver a specified amount of an identified currency at a specified future date. Typically, the price is agreed upon at the time of the contract and payment for such a contract is made at the specified future date. We use currency forwards to reduce market risks from changes in currency exchange rates with respect to investments or liabilities denominated in foreign currencies that we either hold or intend to acquire or sell. We have also used currency forwards to hedge the currency risk associated with net investments in foreign operations.

Equity Contracts

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

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

Credit Contracts

Credit risk relates to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest. We use credit default swaps to enhance the return on our investment portfolio by providing comparable exposure to fixed income securities that might not be available in the primary market. They are also used to hedge credit exposures in our investment portfolio. Credit derivatives are

used to sell or buy credit protection on an identified name or names on an unfunded or synthetic basis in return for receiving or paying a quarterly premium. The premium generally corresponds to a referenced name s credit spread at the time the agreement is executed. In cases where we sell protection, at the same time we enter into these synthetic transactions, we buy a quality cash bond to match against the credit default swap. When selling protection, if there is an event of default by the referenced name, as defined by the agreement, we are obligated to pay the counterparty the referenced amount of the contract and receive in return the referenced security in a principal amount equal to the notional value of the credit default swap.

Other Contracts

Commodity Swaps. Commodity swaps are used to sell or buy protection on commodity prices in return for receiving or paying a quarterly premium. We purchased secured limited recourse notes from VIEs that are consolidated in our financial results. These VIEs use a commodity swap to enhance the return on an investment portfolio by selling protection on a static portfolio of commodity trigger swaps, each referencing a base or precious metal. The portfolio of commodity trigger swaps is a portfolio of deep out-of-the-money European puts on various base or precious metals. The VIEs provide mezzanine protection that the average spot rate will not fall below a certain trigger price on each commodity trigger swap in the portfolio and receive guaranteed quarterly premiums in return until maturity. At the same time the VIEs enter into this synthetic transaction, they buy a quality cash bond to match against the commodity swaps.

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3. Derivative Financial Instruments (continued)

Embedded Derivatives. We purchase or issue certain financial instruments or products that contain a derivative instrument that is embedded in the financial instrument or product. When it is determined that the embedded derivative possesses economic characteristics that are not clearly or 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 for measurement purposes. The embedded derivative, which is reported with the host instrument in the consolidated statements of financial position, is carried at fair value.

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

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

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

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

Exposure

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

Our derivative transactions are generally documented under International Swaps and Derivatives Association, Inc. 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 $301.9 million and $372.8 million in cash and securities under collateral arrangements as of September 30, 2009, and December 31, 2008, respectively, to satisfy collateral requirements associated with our derivative credit support agreements.

Certain of our derivative instruments contain provisions that require us to maintain an investment grade rating from each of the major credit rating agencies on our debt. If the rating on our debt were to fall below investment grade, it would be in violation of these provisions and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that were in a liability position as of September 30, 2009, and December 31, 2008, was $1,395.8 million and $2,100.0 million, respectively, for which we posted collateral of $301.9 million and $372.8 million, respectively, in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered on September 30, 2009, we would be required to post an additional $45.4 million of collateral to our counterparties.

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

3. Derivative Financial Instruments (continued)

As of September 30, 2009, and December 31, 2008, we had received $365.6 million and $262.9 million, respectively, of cash collateral associated with our derivative credit support annex agreements. The cash collateral is included in other assets on the consolidated statements of financial position, with a corresponding liability reflecting our obligation to return the collateral recorded in other liabilities.

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:

	September 30, 2009		December 31, 2008	
	(in millions)			
Notional amounts of derivative instruments				
Interest rate contracts:				
Interest rate swaps	$	**23,287.3**	$	24,148.6
Futures		**27.3**		97.3
Swaptions				94.8
Foreign exchange contracts:				
Foreign currency swaps		**5,409.6**		6,298.7
Currency forwards		**91.6**		52.1
Equity contracts:				
Options		**824.7**		797.5
Futures		**80.3**		63.6
Credit contracts:				
Credit default swaps		**1,774.8**		1,948.9
Other contracts:				
Embedded derivative financial instruments		**3,208.3**		2,938.6
Commodity swaps		**40.0**		40.0
Total notional amounts at end of period	$	**34,743.9**	$	36,480.1
Credit exposure of derivative instruments				
Interest rate contracts:				
Interest rate swaps	$	**791.6**	$	1,105.1
Foreign exchange contracts:				
Foreign currency swaps		**591.9**		562.5
Currency forwards		**4.5**		0.2
Equity contracts:				

Options	**173.0**	222.1
Credit contracts:		
Credit default swaps	**17.5**	70.7
Total gross credit exposure	**1,578.5**	1,960.6
Less: collateral received	**417.5**	284.2
Net credit exposure	**$ 1,161.0**	$ 1,676.4

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Principal Financial Group, Inc.
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3. Derivative Financial Instruments (continued)

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

	Derivative assets (1)		Derivative liabilities (2)	
	September 30, 2009	December 31, 2008	September 30, 2009	December 31, 2008
	(in millions)			
Derivatives designated as hedging instruments				
Interest rate contracts	**$ 134.1**	$ 250.8	**$ 424.1**	$ 819.2
Foreign exchange contracts	**458.0**	410.8	**274.6**	300.4
Total derivatives designated as hedging instruments	**$ 592.1**	$ 661.6	**$ 698.7**	$ 1,119.6
Derivatives not designated as hedging instruments				
Interest rate contracts	**$ 556.1**	$ 802.1	**$ 436.9**	$ 621.5
Foreign exchange contracts	**109.8**	121.3	**77.5**	155.1
Equity contracts	**173.0**	222.1		
Credit contracts	**17.5**	70.7	**99.4**	227.2
Other contracts			**146.3**	185.2
Total derivatives not designated as hedging instruments	**$ 856.4**	$ 1,216.2	**$ 760.1**	$ 1,189.0
Total derivative instruments	**$ 1,448.5**	$ 1,877.8	**$ 1,458.8**	$ 2,308.6

(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 $35.0 million and $60.2 million as of September 30, 2009, and December 31, 2008, 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.

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 $47.0 million and $60.8 million as of September 30, 2009, and December 31, 2008, respectively. These credit derivative transactions had a net fair value gain of $3.9 million and $21.2 million as of September 30, 2009, and December 31, 2008, respectively. Our potential loss could also be reduced by any amount recovered in the default proceedings of the underlying credit name.

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

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3. Derivative Financial Instruments (continued)

The following tables show our credit default swap protection sold by types of contract, types of referenced/underlying asset class and external agency rating for the underlying reference security as of September 30, 2009, and December 31, 2008. The maximum future payments are undiscounted and have not been reduced by the effect of any offsetting transactions, collateral or recourse features described above.

	September 30, 2009			
	Notional amount	Fair value	Maximum future payments	Weighted average expected life (in years)
		(in millions)		
Single name credit default swaps				
Corporate debt				
AA	$ 140.0	$ (1.5)	$ 140.0	4.4
A	514.0	(0.7		