

PRINCIPAL FINANCIAL GROUP INC  
Form 10-K  
February 18, 2009

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

**ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2008

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-16725

**PRINCIPAL FINANCIAL GROUP, INC.**

(Exact name of Registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**711 High Street,  
Des Moines, Iowa 50392**  
(Address of principal executive  
offices)

**42-1520346**  
(I.R.S. Employer  
Identification Number)

**(515) 247-5111**

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class
Common Stock, par value \$0.01
Series B Non-Cumulative Perpetual Preferred Stock

Name of each exchange on which registered
New York Stock Exchange
New York Stock Exchange

Securities registered pursuant to Section 12(g) of  
the Act:

Series A Non-Cumulative Perpetual Preferred Stock
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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No

ý

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

Indicate by check mark if disclosure of delinquent filers pursuant Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K. ☒

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☐

(Do not check if a smaller  
reporting company)

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

As of February 11, 2009, there were outstanding 259,560,962 shares of Common Stock, \$0.01 par value per share of the Registrant.

The aggregate market value of the shares of the Registrant's common equity held by non-affiliates of the Registrant was \$10,868,279,906 based on the closing price of \$41.97 per share of Common Stock on the New York Stock Exchange on June 30, 2008.

### Documents Incorporated by Reference

The information required to be furnished pursuant to Part III of this Form 10-K is set forth in, and is hereby incorporated by reference herein from, the Registrant's definitive proxy statement for the annual meeting of stockholders to be held on May 19, 2009, to be filed by the Registrant with the United States Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the year ended December 31, 2008.

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**NOTE CONCERNING FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K, including the Management's Discussion and Analysis of Financial Condition and Results of Operations, contains statements which constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements relating to trends in operations and financial results and the business and the products of the Registrant and its subsidiaries, as well as other statements including words such as "anticipate," "believe," "plan," "estimate," "expect," "intend" and other similar expressions. Forward-looking statements are made based upon management's current expectations and beliefs concerning future developments and their potential effects on us. Such forward-looking statements are not guarantees of future performance.

Actual results may differ materially from those included in the forward-looking statements as a result of risks and uncertainties. Those risks and uncertainties include, but are not limited to the risk factors listed in Item 1A. "Risk Factors."

## **PART I**

### **Item 1. Business**

Principal Financial Group, Inc. ("PFG") is a leading provider of retirement savings, investment and insurance products and services with \$247.0 billion in assets under management ("AUM") and approximately 19.1 million customers worldwide as of December 31, 2008.

Our U.S. and international operations concentrate primarily on asset accumulation and asset management. In addition, we offer a broad range of individual and group life insurance, group health insurance, individual and group disability insurance and group dental and vision insurance.

We primarily focus on small and medium-sized businesses, which we define as companies with less than 1,000 employees, providing a broad array of retirement and employee benefit solutions to meet the needs of the business, the business owner and their employees. With over 33,000 plans, we are the leading provider of corporate defined contribution plans in the U.S., according to Spectrem Group. We are also the leading employee stock ownership plan consultant. In addition, we are a leading provider of nonqualified plans, defined benefit plans and plan termination annuities. We are also one of the largest providers of specialty benefits insurance product solutions.

We believe small and medium-sized businesses are an underserved market, offering attractive growth opportunities in the U.S. in retirement services and other employee benefits. We also believe there is a significant opportunity to leverage our U.S. retirement expertise into select international markets that have adopted or are moving toward private sector defined contribution pension systems. This opportunity is particularly compelling as aging populations around the world are driving increased demand for retirement accumulation, retirement asset management and retirement income management solutions.

### **Our Reportable Segments**

We organize our businesses into the following reportable segments:

U.S. Asset Accumulation;

Global Asset Management;

International Asset Management and Accumulation and

Life and Health Insurance.

We also have a Corporate segment, which consists of the assets and activities that have not been allocated to any other segment.

See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 19, Segment Information" for financial results of our segments, including our operating revenues for our products and services described in each of the subsequent segment discussions.

### **U.S. Asset Accumulation Segment**

Our asset accumulation activities in the U.S. date back to the 1940s when we first began providing pension plan products and services. We now offer a comprehensive portfolio of asset accumulation products and services for retirement savings and investment:

To businesses of all sizes with a concentration on small and medium-sized businesses, we offer products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans, nonqualified executive benefit plans and employee stock ownership plan ("ESOP") consulting services. For more basic investment needs, we offer SIMPLE IRA and payroll deduction plans;

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To large institutional clients, we also offer investment-only products, including guaranteed investment contracts ("GICs") and funding agreements and

To employees of businesses and other individuals, we offer the ability to accumulate funds for retirement and savings through mutual funds, individual annuities and bank products.

We organize our U.S. asset accumulation operations into six product and service categories: full service accumulation, Principal Funds (our mutual fund business), individual annuities, bank and trust services, investment only and full service payout.

## Full Service Accumulation

### *Products*

We offer a wide variety of investment and administrative products for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans, nonqualified executive benefit plans and ESOPs. A 403(b) plan is a plan described in Section 403(b) of the Internal Revenue Code that provides retirement benefits for employees of tax-exempt organizations and public schools.

Full service accumulation products respond to the needs of plan sponsors seeking both administrative and investment services for defined contribution plans or defined benefit plans. The investment component of both the defined contribution and defined benefit plans may be in the form of a general account, separate account or a mutual fund offering. In addition, defined contribution plans may also offer their own employer security as an investment option.

As of December 31, 2008, we provided full service accumulation products to 33,054 defined contribution pension plans, of which 27,195 were 401(k) plans, covering 3.3 million plan participants, and to 2,710 defined benefit pension plans, covering 351,409 plan participants. As of December 31, 2008, approximately 72% of our full service accumulation account values were managed by our affiliated asset manager, Principal Global Investors. Third-party asset managers provide asset management services with respect to the remaining assets.

We deliver both administrative and investment services to our defined contribution plan and defined benefit plan customers through annuities and mutual funds. Annuities and the underlying investment options are not required to be registered with the United States Securities and Exchange Commission ("SEC"). Our mutual fund offering is called Principal Advantage. It is a qualified plan product based on our series mutual fund, Principal Funds, Inc. We offer investments covering the full range of stable value, equity, fixed income, real estate and international investment options managed by Principal Global Investors as well as third-party asset managers.

### *Markets and Distribution*

We offer our full service accumulation products and services to employer-sponsored pension plans, including qualified and nonqualified defined contribution plans and defined benefit plans. Our primary target market is plans sponsored by small and medium-sized businesses, which we believe remains under-penetrated. According to Spectrem Group, in 2007, only 21% of businesses with between 10 and 99 employees, and 41% of businesses with between 100 and 500 employees, offered a 401(k) plan. The same study indicates that 68% of employers with between 500 and 1,000 employees; 81% of employers with between 1,000 and 5,000 employees; and 86% of employers with 5,000 or more employees offered a 401(k) plan in 2007.

We distribute our full service accumulation products and services nationally, primarily through a captive retirement services sales force. As of December 31, 2008, approximately 325 retirement services sales representatives in over 43 offices, operating as a wholesale distribution network, maintained relationships with over 8,208 independent brokers, consultants and agents. Retirement services sales representatives are an integral part of the sales process alongside the referring consultant or independent broker. We compensate retirement services sales representatives through a blend of salary and production-based incentives, while we pay independent brokers, consultants and agents a commission or fee.

As of December 31, 2008, we had a separate staff of over 229 service and education specialists located in the sales offices who play a key role in the ongoing servicing of pension plans by providing local services to our customers, such as reviewing plan performance, investment options and plan design; communicating the customers' needs and feedback to us and helping employees understand the benefits of their pension plans. The following summarizes our distribution channels:

We distribute our annuity-based products through sales representatives, agents and brokers who are primarily state licensed individuals.

Principal Advantage, our mutual fund-based product, is targeted at defined contribution plans through broker-dealer distribution channels. Principal Advantage gives us access to Financial Industry Regulatory Authority-registered distributors who are not traditional sellers of annuity-based products and broadens opportunities for us in the investment advisor and broker-dealer distribution channels.

Principal Retirement Income Edge® is the latest retirement plan solution from PFG. This program is designed to create a coordinated experience from accumulation to income management for advisors to use with their individual clients and plan participants who are nearing or enjoying retirement. Principal Retirement Income Edge® program provides education and



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planning tools as well as a wide variety of products such as annuities, mutual funds and bank products to provide personalized income management solutions.

Through our Retire Secure strategy we provide financial education and assistance to individual investors who are participants/members of employer-based accumulation solutions to help them achieve financial security.

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We believe that our approach to full service accumulation plan services distribution gives us a local sales and service presence that differentiates us from many of our competitors. We have also established a number of marketing and distribution relationships to increase the sales of our accumulation products.

### **Principal Funds**

We have been providing mutual funds to customers since 1969. We offer mutual funds to individuals, businesses and institutional investors for use within variable life and variable annuity contracts, for use in employer-sponsored pension plans, as a rollover investment option, and for general investment purposes.

### **Products and Services**

Principal Funds plans to grow into a top advisor sold mutual fund company with a sales force focused on multiple channels. As of November 2008, as reported by the Financial Research Corporation, we are ranked 19 (up from 24 in August 2008) according to AUM (long term funds and exchange traded funds only) of the top 50 advisor sold mutual funds. We provide accounting, compliance, corporate governance and product development for all mutual funds we organize. As of December 31, 2008, our mutual fund operations served approximately 1.8 million mutual fund shareholder accounts.

**Principal Funds, Inc.** Principal Funds, Inc. is a series mutual fund, which as of December 31, 2008, offered 72 investment options. This fund acts as the funding vehicle for Principal Advantage, the defined contribution product described above under "U.S. Asset Accumulation Segment-Full Service Accumulation Products." This fund also offers four retail classes of shares to individuals for IRA rollovers ("J shares") and general investment purposes (A, B and C shares) and a class of shares ("I shares") offered primarily to specified institutional investors. As of December 31, 2008, the retail classes of shares had \$20.8 billion in AUM. All other share classes of Principal Funds, Inc., including seed money, had \$17.7 billion of AUM. We report the results for this fund, excluding the retail AUM, under "Full Service Accumulation." We report the results of the retail AUM under "Principal Funds."

**Principal Variable Contracts Funds, Inc.** Principal Variable Contracts Funds, Inc. is a series mutual fund, which, as of December 31, 2008, provided 40 investment options for use as funding choices in variable annuity and variable life insurance contracts issued by Principal Life Insurance Company ("Principal Life") and other insurance companies. As of December 31, 2008, this fund had \$4.6 billion in AUM. AUM backing Principal Life variable annuity contracts is reported in this segment under "Individual Annuities." AUM backing Principal Life variable life insurance contracts is reported in the Life and Health Insurance segment.

**Principal Managed Portfolio.** Principal Managed Portfolio is a wrap product offered by our registered investment advisor, Princor Financial Services Corporation ("Princor"), which permits the client to invest only in Principal Funds, Inc. Clients are charged a quarterly asset-based fee on this account. As of December 31, 2008, Principal Managed Portfolio had accumulated \$482.3 million in assets.

**Principal Advisory Select.** Principal Advisory Select is a non-discretionary wrap product offered by our registered investment advisor, Princor, which permits the client to invest in a broad array of investments. Clients are charged a quarterly asset-based fee on this account. As of December 31, 2008, Principal Advisory Select had accumulated \$744.9 million in assets.

**WM Advisors, Inc.** On December 31, 2006, we completed the purchase of WM Advisors, Inc. and its subsidiaries from Washington Mutual, Inc. for a total cost of \$741.1 million in cash at the time of closing. WM Advisors, Inc. was the manager of the WM Funds, a family of 40 retail and variable contract mutual funds. As of December 31, 2006, the WM Funds acquired had \$22.5 billion in AUM. During 2007, the WM Funds were integrated into the Principal Funds, Inc. and Principal Variable Contracts Funds, Inc.

### **Markets and Distribution**

Our markets for retail mutual funds are individuals seeking to accumulate savings for retirement and other purposes and small businesses seeking to use mutual funds as the funding vehicle for pension plans, as well as nonqualified individual savings plans utilizing payroll deductions. We also market our retail mutual funds to participants in pension plans who are departing their plans and reinvesting their retirement assets into individual retirement accounts.

Our retail mutual funds are sold primarily through our affiliated financial representatives, independent brokers registered with our securities broker-dealer, Princor, registered representatives from other broker-dealers, direct deposits from our employees and others and Principal Connection. Principal Connection is our direct response distribution channel for retail financial services products to individuals. Principal Connection's services are available over the phone, on the Internet or by mail. Princor recruits, trains and supervises registered representatives selling our products. With the WM Advisors, Inc. acquisition, we obtained established relationships with a number of marketing and outside broker-dealer distributors to increase the sales of our mutual fund products.



## Individual Annuities

Individual annuities offer a tax-deferred means of accumulating retirement savings, as well as a tax-efficient source of income during the payout period.

### Products

We offer both fixed and variable annuities to individuals and pension plans. Individual annuities may be categorized in two ways: (1) deferred, in which case assets accumulate until the contract is surrendered, the customer dies or the customer begins receiving benefits under an annuity payout option, or (2) immediate/payout, in which case payments begin within one year of issue and continue for a fixed period of time or for life.

**Fixed Deferred Annuities.** Our individual fixed deferred annuities consist of both single premium deferred annuity contracts and flexible premium deferred annuity contracts ("FPDAs"). Some FPDA contracts limit the period of time deposits are allowed (e.g., only one year). For most contracts, the principal amount is guaranteed. We credit the customer's account with a fixed interest rate and for a specified time period, typically one, three or five years. Thereafter, we reset, typically annually, the interest rate credited to the contract based upon our discretion, taking into account market and other conditions. Our major source of income from fixed deferred annuities is the spread between the investment income earned on the underlying general account assets and the interest rate credited to the contracts. We bear the investment risk because, while we credit customers' accounts with a stated interest rate, we cannot be certain the investment income we earn on our general account assets will exceed that rate. Principal Global Investors manages the assets supporting these contracts.

**Variable Deferred Annuities.** Individual variable deferred annuities are savings vehicles through which the customer makes one or more deposits of varying amounts and intervals. Customers have the flexibility to allocate their deposits to investment sub-accounts managed by Principal Global Investors, or other third-party asset managers. As of December 31, 2008, 73% of our \$3.8 billion in variable annuity account balances was allocated to investment sub-accounts and our general account, which are managed by Principal Global Investors and 27% was allocated to investment sub-accounts managed by third-party asset managers. Generally speaking, the customers bear the investment risk and have the right to allocate their assets among various separate investment sub-accounts. The value of the annuity fluctuates in accordance with the experience of the investment sub-accounts chosen by the customer. Customers have the option to allocate all or a portion of their account to our general account, in which case we credit interest at rates we determine, subject to contractual minimums. Customers may also elect an enhanced death benefit guarantee (commonly known in the industry as a guaranteed minimum death benefit, or "GMDB") and/or a living benefit guarantee (commonly known in the industry as a guaranteed minimum withdrawal benefit, or "GMWB"). We bear the GMDB and GMWB investment risk. We attempt to hedge the GMWB investment risk through the use of sophisticated risk management techniques. As of December 31, 2008, \$1.0 billion of the \$3.8 billion of variable annuity account value has the GMWB rider. Our major source of revenue from variable annuities is mortality and expense fees we charge to the customer, generally determined as a percentage of the market value of the assets held in a separate investment sub-account.

**Fixed Immediate Annuities.** Our individual fixed immediate annuities consist almost exclusively of single premium immediate annuity contracts ("SPIAs"). SPIAs are products where the customer makes a single deposit, and from which periodic benefit payments are made. Payments may be contingent upon the survival of one or two individuals, or payments may be fixed, meaning payments are contractually guaranteed and do not depend on the continuing survival of any individual. Our major source of income from fixed immediate annuities is the spread between the investment income earned on the underlying general account assets and the interest rate implied in the calculation of annuity benefit payments. We bear the investment risk because we cannot be certain the investment income we earn on our general account assets will exceed the rate implied in the SPIA contracts. Principal Global Investors manages the assets supporting these contracts.

### Markets and Distribution

Our target markets for individual annuities include owners, executives and employees of small and medium-sized businesses, and individuals seeking to accumulate and/or eventually receive distributions of assets for retirement. We market both fixed and variable annuities to both qualified and nonqualified pension plans.

We sell our individual annuity products through our affiliated financial representatives, who accounted for 20%, 26% and 40% of annuity sales for the years ended December 31, 2008, 2007 and 2006, respectively. The remaining sales were made through banks, brokerage general agencies, mutual fund companies, Principal Connection and unaffiliated broker-dealer firms. Although the overall percentage of sales from affiliated financial representatives has declined, they continued to be the primary distribution channel of our variable deferred annuities. The overall percentage decline is a result of focused efforts to increase fixed annuity sales through non-affiliated distribution channels.

## **Bank and Trust Services**

Bank and trust services include Principal Bank and Principal Trust Company. Principal Bank is a federal savings bank that began its activities in February 1998. We market flexible banking products and services via other PFG affiliates, the telephone or Internet. Our current products and services include a suite of consumer checking and savings accounts, money market accounts, certificates of deposit, consumer loans, home equity loans, home equity lines of credit, credit cards, debit cards, small account rollovers from qualified retirement plans and health savings accounts ("HSAs"). In addition, we offer deposit and loan services to small and medium-sized businesses. As of December 31, 2008, Principal Bank had approximately 210,000 customers and approximately \$2.3 billion in assets.

We market our Principal Bank products and services to prospects and our existing customers, through Principal Connection, our affiliated financial representatives and other PFG affiliates with a primary focus on deepening existing relationships with customers of PFG. We also pursue asset retention strategies with our customers who seek to transfer assets from our other asset accumulation products by offering them our banking products and services.

Principal Trust Company is a Delaware state chartered non-deposit trust company. Principal Trust Company, chartered in 1899 as Delaware Charter Guarantee and Trust Company, is one of the largest non-deposit trust companies in the nation. As of December 31, 2008, we served as trustee to over 365,000 accounts and held assets of \$60.6 billion. Principal Trust Company may not accept deposits and cannot make personal or commercial loans.

Principal Trust Company specializes in providing trust solutions directed at self-directed tax-advantaged savings accounts, such as Individual Retirement Accounts ("IRAs"), personal trusts and a full array of employee benefit plans and accounts including 401(k) and 403(b) plans, defined benefit pension plans, nonqualified executive benefit plans and ESOPs. We market our trust services to our customers through our PFG affiliates and through non-affiliated brokerage firms, clearing firms, financial advisors and asset managers.

## **Investment Only**

### ***Products***

The three primary products for which we provide investment only services are: GICs; funding agreements and other investment only products.

GICs and funding agreements pay a specified rate of return. The rate of return can be a floating rate based on an external market index or a fixed rate. Our investment only products contain provisions disallowing or limiting early surrenders, including penalties for early surrenders and minimum notice requirements.

Deposits to investment only products are predominantly in the form of single payments. As a result, the level of new deposits can fluctuate from one fiscal quarter to another. Assets invested in GICs and funding agreements generate a spread between the investment income earned by us and the amount credited to the customer. Our other investment only products consist of separate accounts invested in either equities or fixed income instruments. Principal Global Investors manages the assets supporting investment only account values.

### ***Markets and Distribution***

We market GICs and funding agreements primarily to pension plan sponsors and other institutions. We also offer them as part of our full service accumulation products. We sell our GICs primarily to plan sponsors for funding of tax-qualified retirement plans. We sell our funding agreements directly to institutions that may or may not be pension funds and unconsolidated special purpose vehicles domiciled either in the U.S. or offshore for funding agreement-backed note programs. The funding agreements sold as part of these funding agreement-backed note programs work by having investors purchase debt obligations from the special purpose vehicle which, in turn, purchases the funding agreement from us with terms similar to those of the debt obligations. The strength of this market is dependent on debt capital market conditions. As a result, our sales through this channel can vary widely from one quarter to another. In addition to the special purpose vehicle selling the funding agreement-backed notes to U.S. and foreign institutional investors, the special purpose vehicle may also sell notes to U.S. retail investors through a SEC-registered shelf debt issuance program. Due to a downturn in the credit market, we reduced the amount of medium term note and GIC issuances in 2008. As economic conditions change, we will reassess the use of our medium term note and GIC programs.

## **Full Service Payout**

### ***Products***

Full service payout products respond to the needs of pension plan participants who, upon retirement or termination of their employment, seek a guaranteed income stream. Plan participants who seek these services include those from pension plans we service, as well as pension

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plans other providers service. We primarily offer single premium group annuities, which are immediate or deferred annuities that provide a current or future specific income amount, fully guaranteed by us. These are available to defined contribution and defined benefit plan participants. We make regular

payments to individuals, invest the underlying assets on their behalf and provide tax reporting to them. We also reinsure single premium immediate annuities issued by another insurer.

Single premium group annuities are traditionally used in conjunction with defined benefit plans, particularly those where the plan is being terminated. In such instances, the plan sponsor transfers all its obligations under the plan to an insurer by paying a single premium. Increasingly, these products are purchased by defined contribution plan participants who reach retirement age. Generally, plan sponsors restrict their purchases to insurance companies with superior or excellent financial quality ratings because the Department of Labor has mandated that annuities be purchased only from the "safest available" insurers.

Premium received from full service payout products are generally in the form of single payments. As a result, the level of new premiums can fluctuate depending on the number of retirements and large-scale annuity sales in a particular fiscal quarter. Principal Global Investors manages the assets supporting full service payout account values.

### ***Markets and Distribution***

Our primary distribution channel for full service payout products is comprised of several specialized home office sales consultants working through consultants and brokers that specialize in this type of business. Our sales consultants also make sales directly to institutions. Our nationally dispersed retirement services sales representatives act as a secondary distribution channel for these products. Principal Connection also distributes full service payout products to participants in plans we service who are terminating employment or retiring.

### **Global Asset Management Segment**

Our Global Asset Management segment consists of Principal Global Investors and its affiliates. We focus on providing a diverse range of asset management services covering a broad range of asset classes, investment styles and portfolio structures to our other segments and third-party institutional clients.

As of December 31, 2008, Principal Global Investors, together with its affiliates, Principal Real Estate Investors, Spectrum Asset Management, Post Advisory Group, Columbus Circle Investors, Edge Asset Management and Morley Financial Services managed \$190.0 billion in assets. Morley Financial Services was acquired on August 31, 2007. Edge Asset Management was acquired on December 31, 2006, as part of the WM Advisors, Inc. acquisition. We have offices outside of the U.S. in Australia, Hong Kong, Japan, Singapore and the United Kingdom.

### ***Products and Services***

#### **Fee Mandate Business**

Our fee mandate business provides focused investment advisory services across a broad range of asset classes, investment styles and portfolio structures. These services are provided for a fee as defined by the client mandate. We are diversified across three primary asset classes.

***Equity Investments.*** As of December 31, 2008, Principal Global Investors, along with Columbus Circle Investors and Edge Asset Management managed \$41.9 billion in global equity assets. Our equity capabilities encompass large-cap, mid-cap and small-cap stocks in developed and emerging markets worldwide. As of December 31, 2008, 38% of equity AUM was derived from our pension products, 30% from other products of PFG and the remaining 32% from third-party institutional clients.

***Fixed Income Investments.*** Principal Global Investors, along with Spectrum Asset Management, Post Advisory Group, Edge Asset Management and Morley Financial Services managed \$108.4 billion in global fixed income assets as of December 31, 2008. Collectively, we provide our clients with access to investment-grade corporate debt, government bonds, mortgage-backed, asset-backed and commercial mortgage-backed securities, high yield and municipal bonds, private and syndicated debt instruments and preferred securities. As of December 31, 2008, 35% of these assets were derived from our pension products, 24% from other products of PFG, and the remaining 41% from third-party institutional clients.

***Real Estate Investments.*** Principal Global Investors, through its affiliate Principal Real Estate Investors, managed a portfolio of primarily U.S. commercial real estate assets of \$36.9 billion as of December 31, 2008. Principal Real Estate Investors provides our clients with a broad range of real estate investment options, including private real estate equity, commercial mortgages, credit tenant debt, construction-permanent financing, bridge/mezzanine loans, commercial mortgage-backed securities and real estate investment trusts. As of December 31, 2008, 40% of the commercial real estate portfolio was derived from our pension products, 27% from other products of PFG and the remaining 33% from third-party institutional clients.





## **Spread and Securitization Business**

Our spread and securitization business consists of Principal Commercial Acceptance and our terminated commercial mortgage securities issuance operation. Principal Commercial Acceptance offers commercial real estate niche financing opportunities, including bridge/mezzanine loans and land loans. We had \$0.3 billion of bridge/mezzanine loans as of December 31, 2008, and we are no longer originating new loans for this business. During the third quarter of 2008, we made a decision to terminate our commercial mortgage securities issuance operation, which does not qualify for discontinued operations treatment under U.S. generally accepted accounting principles ("U.S. GAAP"), but is excluded from segment operating earnings for all time periods presented.

## **Markets and Distribution**

We employed 132 institutional sales, relationship management and client service professionals as of December 31, 2008, who worked with consultants and directly with large investors to acquire and retain third-party institutional clients. As of December 31, 2008, Principal Global Investors and its affiliates have approximately 500 third-party institutional clients with \$70.3 billion of AUM in 53 countries.

## **International Asset Management and Accumulation Segment**

Our International Asset Management and Accumulation segment consists of Principal International, which has operations in Brazil, Chile, China, Hong Kong Special Administrative Region ("SAR"), India, Indonesia, Malaysia, Mexico and Singapore. We focus on countries with large middle classes, favorable demographics and growing long-term savings with defined contribution markets. We entered these countries through acquisitions, start-up operations and joint ventures.

The activities of Principal International reflect our efforts to accelerate the growth of our AUM by capitalizing on the international trend toward private sector defined contribution pension systems and individual long-term savings. Through Principal International, we offer retirement products and services, annuities, mutual funds, institutional asset management and life insurance accumulation products.

## **Products, Markets and Distribution**

**Brazil.** In Brazil, we offer pension, retirement and asset accumulation products through a minority-held joint venture, Brasilprev Vida e Previdência, arrangement with Banco do Brasil, which had over a 4,000 branch network as of September 30, 2008. Brasilprev has an exclusive agreement with Banco do Brasil in order to distribute pension, retirement and long-term asset accumulation products. Our joint venture provides defined contribution products, complementary life protection and payout solutions such as permanent and temporary annuities for the retirement needs of employers and individuals. Banco do Brasil's employees sell these products directly to individual clients through its bank branches. In addition, our joint venture reaches corporate clients through two wholesale distribution channels: (1) a network of independent brokers who sell to the public and (2) Banco do Brasil's corporate account executives selling to existing and prospective corporate clients. Based upon managed assets, our joint venture ranked third in the private pension market as of November 2008.

**Chile.** In Chile, we offer long-term savings products, retirement annuities, mutual funds, life insurance accumulation products, mortgage loans and institutional asset management services.

We offer retirement annuities to individuals exiting the pre-retirement accumulation system. We distribute our annuity products through a network of brokers and independent agents, of which we had approximately 400 as of December 31, 2008.

We serve the individual voluntary/complementary long-term savings market by offering "APV plans" (qualified individual retirement solutions) and "APVC plans", which are similar to the U.S. 401(k) product line. As of September 30, 2008, we ranked first in AUM for mutual fund companies offering these plans. We distribute to retail clients through our proprietary sales force, financial advisors, brokerage houses, alliances with financial institutions and the largest retailer in Chile, Falabella.

In addition, we offer life insurance accumulation products (qualified and nonqualified) to individuals through brokers and financial advisors. We originate, sell and service individual residential mortgage loans in Chile through our independent distribution network, composed primarily of real estate brokers and developers. We also offer asset management services to pension funds, insurance companies, mutual fund companies and investment platforms through our proprietary sales force.

**China.** In China, we offer mutual funds through a minority-held joint venture with China Construction Bank ("CCB"). We sell mutual funds primarily through our partner bank, CCB. This bank delivers expansive distribution capabilities for the joint venture in terms of brand awareness and the number of outlets, of which we had approximately 14,000 as of December 31, 2008.

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**Hong Kong SAR.** In Hong Kong, we sell defined contribution pension, mutual fund and institutional asset management products.

We actively compete in the defined contribution pension plan market. The government requires both employers and employees to contribute 5% of an employee's income to a Mandatory Provident Fund ("MPF"). We target small and medium-sized employers and distribute products through strategic alliances with insurance companies, brokers, consultants, banks and direct marketing through our own sales representatives. Our alliance partners distribute our MPF products and services or use our administrative and investment services in their own products.

We compete in the Hong Kong mutual fund market with distribution provided primarily through strategic alliances with banks to retail customers. The institutional segment has placed an emphasis on platform sales to unit-linked insurance providers and MPF providers, with the advantage of getting regular inflows. In an effort to grow institutional asset management, Hong Kong will leverage Principal Global Investors' regional asset management and sales resources to jointly secure mandates.

**India.** In India, we offer mutual funds and asset management services to both retail and corporate customers.

We compete in the mutual fund market, managing and administering funds for both individuals and corporations through a majority-owned joint venture with Punjab National Bank and Vijaya Bank ("Banks"), two large Indian commercial banks with a combined branch network of approximately 5,500. We sell our mutual funds through regional offices and other bank branches located throughout India. In addition to the current mutual fund business, we are positioning ourselves to compete in the emerging pension and long-term savings market in India.

Discussions are taking place with our partners to review the optimal ownership and organizational structure for the future.

**Malaysia.** In Malaysia, we offer conventional and Islamic mutual funds through our minority-held joint venture with CIMB Group, a large Malaysian bank holding company with a presence in many southeast Asian countries. The company markets mutual funds through wholesale bank channels and its own sales force of around 6,500 agents. The joint venture's main bank channel is through the approximately 400 CIMB Bank branches. As of December 31, 2008, our joint venture company ranked third in unit trust assets managed and second in Islamic unit trust assets managed in the Malaysian asset management industry. In addition, the company manages a significant amount of institutional asset mandates ranking second among asset management companies as of September 30, 2008. The joint venture began an asset management start-up operation in Singapore, CIMB-Principal Asset Management (S) Pte Ltd, in 2007. Through the Malaysia joint venture, we acquired a small asset management operation in Indonesia, PT Niaga Aset Manajemen, as well as the fund business of CIMB-GK in 2008.

**Mexico.** In Mexico, we offer defined contribution pension products, mutual funds, annuities and asset management services to institutional clients.

Through our private pension company, we manage and administer more than 2.9 million individual retirement accounts under the mandatory privatized social security system for all non-government employees in Mexico. We distribute products and services through a proprietary sales force of sales representatives, of which we had approximately 1,200 as of December 31, 2008, as well as independent brokers, who sell directly to individuals.

Through our mutual fund company, we distribute products and services through a sales force of approximately 100 employees and through distribution agreements with other financial entities. We administer annuities and life products that complement these annuities, which we previously distributed directly to customers who were exiting the pre-retirement accumulation system. We suspended sales of our annuity and life products in Mexico beginning in 2007 due to unfavorable market conditions.

Our focus is on both pre-retirement and post-retirement savings plans. Mexico has also initiated institutional asset management services, offering both domestic and international products.

### **Life and Health Insurance Segment**

Our Life and Health Insurance segment offers individual life insurance, group health insurance and specialty benefits, which includes group dental, group vision, group life, group long-term disability, group short-term disability and individual disability insurance throughout the U.S. We focus on providing comprehensive insurance solutions for small and medium-sized businesses.

#### **Individual Life Insurance**

We began as an individual life insurer in 1879. Our U.S. operations administer approximately 600,000 individual life insurance policies with \$121.3 billion of individual life insurance in force as of December 31, 2008. As of September 30, 2008, our life insurance business was ranked 17th in the U.S. for annualized sales according to LIMRA.



### ***Products and Services***

We offer a variety of individual life insurance products, including universal and variable universal life insurance and term life insurance. We target the personal insurance needs of owners and executives of small and medium-sized businesses and have an increasing focus on also using these products for nonqualified executive benefits. In addition, we also market our products to meet traditional retail insurance needs.

***Nonqualified Executive Benefits.*** Small and medium-sized companies are challenged with how to build quality benefits packages for executives, how to transition the company's ownership to a partner or family member and how to save for retirement. In addition, executives and other key employees often have personal insurance needs. These needs are the focus of our products within the individual life insurance arena.

We have a growing focus and expertise in providing executive life insurance benefits to companies designated by the Internal Revenue Service ("IRS") as S corporations, in addition to traditional C corporation clients. As a growing segment of the small and medium-sized business market, S corporations require unique plan designs that meet very specific legal requirements.

***Universal and Variable Universal Life Insurance.*** Universal and variable universal life insurance products offer life insurance protection for which both the premium and the death benefit may be adjusted by the policyholder. Universal life insurance usually includes a cash value account that accumulates at a credited interest rate based on the investment returns of the block of business. Variable universal life insurance is credited with the investment returns of the various investment options selected. For the year ended December 31, 2008, 90% of individual life insurance annualized first year premium sales have come from universal and variable universal life insurance products. Universal and variable universal life insurance represents 61% of individual life insurance premium and deposits for the year ended December 31, 2008, and 48% of individual life insurance in force as of December 31, 2008. Variable universal life insurance products represented 41% of our universal and variable universal life insurance deposits for the year ended December 31, 2008.

After a deduction for policy level expenses, we credit net deposits to an account maintained for the policyholder. For universal life contracts, the entire account balance is invested in our general account. Interest is credited to the policyholder's account based on the earnings on general account investments. For variable universal life contracts, the policyholder may allocate the account balance among our general account and a variety of separate account choices. Interest is credited on amounts allocated to the general account in the same manner as for universal life. Net investment performance on separate account investments is allocated directly to the policyholder accounts; the policyholder bears the investment risk. Some of our universal life and variable universal life insurance contracts contain what are commonly referred to as "secondary" or "no-lapse" guarantee provisions. A no-lapse guarantee keeps the contract in force, even if the contractholder's account balance is insufficient to cover all of the contract charges, provided that the contractholder has continually paid a specified minimum premium.

***Traditional Life Insurance.*** Traditional life insurance includes participating whole life, adjustable life products and non-participating term life insurance products. Participating products and non-participating term life insurance products each represented 5% of our individual life insurance annualized first year premium sales for the year ended December 31, 2008, and 25% and 27%, respectively, of individual life insurance in force as of December 31, 2008. Adjustable life insurance products provide a guaranteed benefit in return for the payment of a fixed premium and allow the policyholder to reset the premium and face amount combination. Term insurance products provide a guaranteed death benefit for a specified period of time in return for the payment of a fixed premium. Policyholder dividends are not paid on term insurance.

### **Group Health Insurance**

We began offering group health insurance in 1941. We offer a variety of traditional group medical insurance products, consumer driven high deductible health plans with HSAs, administrative services and wellness products. We provide administrative services on a fee-for-service basis for medical, dental, disability, vision and wellness benefits.

### ***Products and Services***

Our group health insurance products described below include a range of programs and services designed to meet the needs of our members across the health care continuum. These programs include the spectrum of wellness services, utilization management, case management, disease management and specialty programs including transplant services. Members have access to online health management resources including a broad range of health content, symptom checkers, prescription drug information and provider information. The programs are designed to promote informed health care consumers, advance evidence based medicine and to optimize both the quality and cost of health care received by our members.

***Group Health Insurance.*** As of December 31, 2008, we provided group medical insurance benefits to more than 16,800 employer customers and their 449,000 employees and dependents. Our traditional group medical insurance plans

provide reimbursement of medical expenses for insured employees and their dependents. These members are responsible for deductibles, co-payments and co-insurance. Through our wholly owned subsidiary, HealthRisk Resource Group, LLC., we negotiate discounts with providers on claims for which we have no other pre-arranged discount.

Our consumer-driven health care plans offer greater flexibility for employers and more opportunity for members to take charge of their health and health care. We offer the Principal Health Savings Account, which features a checking account with a debit card and certificates of deposit through Principal Bank and investment options through Princor.

***Fee-for-Service.*** We offer administration of group medical, dental, disability and vision benefits on a fee-for-service basis to over 310 self-insured employers and their approximately 735,000 employees and dependents as of December 31, 2008.

***Wellness Company.*** We recognize the importance of promoting healthy behavior. Principal Wellness Company contributes expertise in providing wellness screenings, counseling and services to employers and their employees, demonstrating health improvement through reduced health insurance claim costs, reduced absenteeism and increased employee productivity. This preventative focus has been integrated into both our fully-insured and fee-for-service offerings. We provide wellness services to over 420 employers and their 138,000 employees.

### **Specialty Benefits**

Specialty benefits, which includes group dental, vision and life insurance, as well as individual and group disability insurance, is an important component of the employee benefit offering at small and medium-sized businesses. We offer traditional employer sponsored and voluntary products for group dental, vision, life and disability. We began selling our first specialty benefit products in 1941 with group disability and group life insurance. We began selling individual disability insurance in 1952 and group dental and group vision insurance in the late 1960s.

### ***Products and Services***

***Group Dental and Vision Insurance.*** Group dental and vision insurance plans provide partial reimbursement for dental and vision expenses. As of December 31, 2008, we had approximately 36,000 group dental and vision insurance policies in force covering over 943,000 employee lives. According to LIMRA, we were the 5th largest group dental insurer in terms of number of contracts/employer groups in force in 2007. In addition to indemnity and preferred provider organization dental offered on both an employer paid and voluntary basis, we offer a prepaid dental plan in Arizona through our Principal Dental Services, Inc. subsidiary.

***Group Life Insurance.*** Group life insurance provides coverage to employees and their dependents for a specified period. As of December 31, 2008, we had nearly 49,600 group policies providing \$121.0 billion of group life insurance in force to approximately 2.1 million employee lives. According to LIMRA in 2007, we were ranked 3rd in the U.S. in terms of the number of life insurance contracts in force. We currently sell traditional group life insurance that does not provide for accumulation of cash values on both an employer paid and voluntary basis. Our group life insurance business remains focused on the traditional, annually renewable term product. Group term life and group universal life accounted for 96% and 4%, respectively, of our total group life insurance in force as of December 31, 2008. We no longer market group universal life insurance to new employer groups.

***Group Disability Insurance.*** Group disability insurance provides a benefit to insured employees who become disabled. Our group disability products include both short-term and long-term disability, offered on both an employer paid and voluntary basis. Long-term disability represents 62% of total group disability premium, while short-term disability represents 38% of total group disability premium. In addition, we provide disability management services, also called rehabilitation services, to assist individuals in returning to work as quickly as possible following disability. We also work with disability claimants to improve the approval rate of Social Security benefits, thereby reducing payment of benefits by the amount of Social Security payments received. As of December 31, 2008, we served approximately 1.4 million employee lives under nearly 31,000 contracts, with our group short-term disability business being ranked 4th and our group long-term disability business being ranked 7th in the U.S. as of December 31, 2007, in terms of number of contracts/employer groups in force, according to LIMRA.

***Individual Disability Insurance.*** Individual disability insurance products provide a benefit to the insured member in the event he/she becomes disabled. In most instances, this benefit is in the form of a monthly income. In addition to income replacement, we offer products to pay business overhead expenses for a disabled business owner and for the purchase by the other business owners of the disabled business owner's interests in the business. As of December 31, 2008, we served approximately 120,000 individual disability policyholders, with our individual disability business being ranked 7th in the U.S. as of December 31, 2007, in terms of premium in force, according to LIMRA.

### ***Life and Health Markets and Distribution***

For each of our products, administration and distribution channels are customized to meet customer needs and expectations for that product.

We sell our individual life and individual disability income products in all 50 states and the District of Columbia, primarily targeting owners and executives of small and medium-sized businesses. Small and medium-sized business sales represented 83% of individual life sales and 63% of individual disability sales for the year ended December 31, 2008, based on first year annualized premium.

We distribute our individual insurance products through our affiliated financial representatives and independent brokers, as well as other marketing and distribution alliances. Affiliated financial representatives were responsible for 29% of individual life insurance sales based on first year annualized premium and 17% of individual disability sales for the year ended December 31, 2008. We had 1,050 affiliated financial representatives in 30 offices. Although they are independent contractors, we have a close tie with affiliated financial representatives and we offer them benefits, training and access to tools and expertise. To meet the needs of the various marketing channels, particularly the independent brokers, we employ wholesale distributors. Regional Vice Presidents for individual life and Disability Income Regional Vice Presidents for individual disability. A key differentiator in the nonqualified executive benefit sale is our Regional Vice Presidents-Nonqualified Plans, who are not only wholesalers but also consultants and subject-matter experts providing point-of-sale support in closing cases.

We market our group medical, life, disability, dental and vision insurance products to small and medium-sized businesses, primarily targeting our sales toward owners and human resources professionals. We sell our group life, disability and dental products in all 50 states and the District of Columbia. We sell vision coverage in 48 states, plus the District of Columbia. We sell our group medical insurance in 34 states and the District of Columbia. We continually adapt our products and pricing to meet local market conditions. We market our fee-for-service capabilities to employers that self-insure their employees' benefits. We sell our fee-for-service business in all 50 states and the District of Columbia.

Group insurance and fee-for-service products are distributed through independent benefit brokers, consultants, financial planners and the same channels that sell our U.S. asset accumulation products. To reach these marketers, we employ three types of wholesale distributors: our medical sales representatives, our non-medical sales representatives (for Specialty Benefits products) and an independent wholesale organization to market group medical, life, disability, dental and vision insurance products. We have also formed a number of strategic distribution alliances with national brokerages and regional brokerage agencies.

The non-medical group insurance market continues to see a shift to voluntary/worksites products. In keeping with this market change, which shifts the funding of such products from the employer to the employee, we have enhanced our focus on our voluntary benefits platform. We believe the voluntary/worksites market presents growth opportunities, and we will continue to develop strategies to capitalize on this expanding market.

As of December 31, 2008, we had 132 medical and non-medical sales representatives and 124 service representatives in 38 offices. Our medical and non-medical sales representatives accounted for 74% of our group insurance sales for the year ended December 31, 2008. The group sales force plays a key role in the ongoing servicing of the case by providing local, responsive services to our customers and their brokers, such as renewing contracts, revising plans and solving any administrative issues; communicating the customers' needs and feedback to us; and helping employees understand the benefits of their plans.

### **Corporate Segment**

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

### **Competition**

Competition in our segments is based on a number of factors including: scale, service, product features, price, investment performance, commission structure, distribution capacity, financial strength ratings and name recognition. We compete with a large number of financial services companies such as banks, mutual funds, broker-dealers, insurers and asset managers. Some of these companies offer a broader array of products, more competitive pricing, greater diversity of distribution sources, better brand recognition or, with respect to insurers, higher financial strength ratings. Some may also have greater financial resources with which to compete or may have better investment performance at various times.

Competition in the retirement services market is very fragmented. Our main competitors in this market include Fidelity, ING, Mass Mutual, Vanguard and John Hancock. We believe the infrastructure and system support needed to meet the needs of the small and medium-sized

business market is a significant barrier to entry for our competitors. Many

of our competitors in the mutual fund industry are larger, have been established for a longer period of time, offer less expensive products, have deeper penetration in key distribution channels and have more resources than we do. There were over 8,000 mutual funds in the U.S. as of December 31, 2007 according to the ICI 2008 Investment Company Fact Book. The institutional asset management market has grown at a rapid pace over the last decade. Our primary competitors in this market are large institutional asset management firms, such as Black Rock, PIMCO, J.P. Morgan Chase, Morgan Stanley Investment Management and T. Rowe Price, some of which offer a broader array of investment products and services and are better known. The asset management business has relatively few barriers to entry and continually attracts new entrants. The variable annuity market is also highly competitive. We will face strong competition from Lincoln Financial Group and John Hancock. Competition in the international markets in which we operate comes primarily from local financial services firms and other international companies operating on a stand-alone basis or in a partnership with local firms, including ING, AXA, Allianz and American International Group, Inc. ("AIG"). In the highly competitive life and health insurance business, our competitors include other insurers and managed health care organizations such as UNUM, Lincoln Financial Group, MetLife, Manulife, Blue Cross and Blue Shield, UnitedHealthcare, Aetna and CIGNA. We believe we distinguish ourselves from our competitors through our:

full service platform;

strong customer relationships;

focus on financial performance and

performance-oriented culture.

## Ratings

Insurance companies are assigned financial strength ratings by rating agencies based upon factors relevant to policyholders. Financial strength ratings are generally defined as opinions as to an insurer's financial strength and ability to meet ongoing obligations to policyholders. Information about ratings provides both industry participants and insurance consumers meaningful insights on specific insurance companies. Higher ratings generally indicate financial stability and a stronger ability to pay claims.

Principal Life has been assigned the following long-term insurance financial strength ratings:

Rating Agency	Financial Strength Rating	Rating Structure
A.M. Best Company, Inc.	A+ ("Superior") with a stable outlook	Second highest of 16 rating levels
Fitch Ratings	AA- ("Very Strong") with a rating watch negative outlook	Fourth highest of 21 rating levels
Moody's Investors Service	Aa2 ("Excellent") with a negative outlook	Third highest of 21 rating levels
Standard & Poor's Rating Services	AA ("Very Strong") with a credit watch negative outlook	Third highest of 21 rating levels

A.M. Best's ratings for insurance companies range from "A++" to "S". A.M. Best indicates that "A++" and "A+" ratings are assigned to those companies that in A.M. Best's opinion have superior ability to meet ongoing obligations to policyholders. Fitch's ratings for insurance companies range from "AAA" to "C". Fitch "AA" ratings indicate very strong capacity to meet policyholder and contractholder obligations on a timely basis. Moody's Investors Service ratings for insurance companies range from "Aaa" to "C". Moody's Investors Service indicates that "Aa" ratings are assigned to those companies that have demonstrated excellent financial security. Standard & Poor's ratings for insurance companies range from "AAA" to "R". Standard & Poor's indicates that "AA" ratings are assigned to those companies that have demonstrated very strong financial security characteristics. In evaluating a company's financial and operating performance, these rating agencies review its profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its policy reserves, the soundness of its risk management programs, the experience and competency of its management and other factors. The four rating agencies referenced have placed negative outlooks on the U.S. life insurance industry. A negative outlook means that the rating of many U.S. life insurance companies may be downgraded due to the impact of negative market conditions.

We believe that our strong ratings are an important factor in marketing our products to our distributors and customers, since ratings information is broadly disseminated and generally used throughout the industry. Our ratings reflect each rating agency's opinion of our financial strength, operating performance and ability to meet our obligations to policyholders and are not evaluations directed toward the protection of



investors. Such ratings are neither a rating of securities nor a recommendation to buy, hold or sell any security, including our common stock. For more information on ratings, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations    Liquidity and Capital Resources    Financial Strength Rating and Credit Ratings."

## Regulation

Our businesses are subject to regulation and supervision by U.S. federal and state regulatory authorities as well as non-U.S. regulatory authorities for our operations outside the U.S., which can have a significant effect on our business. Our businesses are also affected by U.S. federal, state and local tax laws as well as tax laws for jurisdictions outside the U.S.

PFG, our parent holding company, is not licensed as an insurer, investment advisor, broker-dealer, bank or other regulated entity. However, because it is the holding company for all of our operations, it is subject to regulation of our regulated entities, including as an insurance holding company and savings and loan holding company. We are subject to legal and regulatory requirements applicable to public companies, including public reporting and disclosure, securities trading, accounting and financial reporting and corporate governance.

### *U.S. Insurance Regulation*

We are subject to the insurance holding company laws in the states where our insurance companies are domiciled. Principal Life and Principal National Life Insurance Company are domiciled in Iowa and their principal insurance regulatory authority is the Insurance Division of the Department of Commerce of the State of Iowa. Our other U.S. insurance companies are principally regulated by the insurance departments of the states in which they are domiciled. These laws generally require each insurance company directly or indirectly owned by the holding company to register with the insurance department in the insurance company's state of domicile and to furnish financial and other information about the operations of the companies within the holding company system. Transactions affecting the insurers in the holding company system must be fair and at arm's length. Most states have insurance laws that require regulatory approval of a direct or indirect change in control of an insurer or an insurer's holding company and laws requiring prior notification of state insurance departments of a change in control of a non-domiciliary insurance company doing business in that state.

Annually, our U.S. insurance companies must submit an opinion from a board-appointed qualified actuary to state insurance regulators, where licensed, on whether the statutory assets held backing statutory reserves are sufficient to meet contractual obligations and related expenses of the insurer. If such an opinion cannot be rendered noting the sufficiency of assets, then the insurance company must set up additional statutory reserves drawing from available statutory surplus until such an opinion can be given.

State insurance departments have broad administrative powers over the insurance business, including insurance company licensing and examination, agent licensing, establishment of reserve requirements and solvency standards, premium rate regulation, admittance of assets to statutory surplus, policy form approval, unfair trade and claims practices regulation and other matters. State insurance statutes also typically place restrictions and limitations on the amount of dividends or other distributions payable by insurance company subsidiaries to their parent companies. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources" for further detail.

In order to enhance the regulation of insurer solvency, the National Association of Insurance Commissioners ("NAIC") has established risk-based capital standards. The standards require life insurers to submit a report to state regulators on an annual basis regarding their risk-based capital based upon four categories of risk: asset risk, insurance risk, interest rate risk and business risk. As of December 31, 2008, the statutory surplus of each of our U.S. life insurance companies exceeded the minimum level of risk-based capital requirements required before state insurance departments would take action against an insurer.

State and federal insurance and securities regulatory authorities and other state law enforcement agencies and attorneys general regularly make inquiries and conduct examinations or investigations regarding our compliance with, among other things, insurance laws and securities laws.

Each state has insurance guaranty association laws under which insurers doing business in a state can be assessed, up to prescribed limits, in order to cover contractual benefit obligations of insolvent insurance companies. The guaranty associations levy assessments on each member insurer in a jurisdiction on the basis of the proportionate share of the premiums written by such insurer in the lines of business in which the insolvent insurer is engaged. Some jurisdictions permit the member insurers to recover the assessments paid through full or partial premium tax offsets.

### *Securities Regulation*

Insurance and investment products such as variable annuities, variable life insurance and some funding agreements that constitute securities and mutual fund products are subject to securities laws and regulations, including state securities regulation as well as federal regulation under the SEC, the Financial Industry Regulatory Authority and other regulatory authorities. These regulations affect investment advice, sales and related activities for these products.

We also have entities which are registered as investment advisers with the SEC under the Investment Advisers Act of 1940.



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### ***Employee Retirement Income Security Act***

As we provide products and services for U.S. employee benefit plans, we are subject to regulation under the Employee Retirement Income Security Act ("ERISA"). ERISA provisions include reporting and disclosure requirements and standards of conduct.

### ***Banking Regulation***

We are a savings and loan holding company for Principal Bank, a federal savings bank, which is regulated by the Office of Thrift Supervision. Principal Bank is also a member of the Federal Deposit Insurance Corporation ("FDIC") and subject to its regulations.

### ***Environmental Regulation***

As we own and operate real property, we are subject to federal, state and local environmental laws and could be subject to environmental liabilities and costs associated with required remediation of our properties. We routinely have environmental assessments performed for real estate being acquired or used as collateral for commercial mortgages we use for investment.

### ***Regulation of International Businesses***

Our international businesses are supervised by regulatory authorities in the jurisdictions in which they operate.

### **Risk Management**

Like all financial services companies, we are exposed to a wide variety of financial, operational and other risks, as described in Item 1A. "Risk Factors." Effective enterprise risk management is, therefore, a key component of our business model. Enterprise risk management helps us to:

identify and manage those risks that present profitable growth opportunities, and avoid those that do not and

balance the sometimes competing demands of our various stakeholders, meet our customer obligations, satisfy regulatory requirements and optimize shareholder returns relative to the risks we take.

We use a variety of methods to help us identify, monitor, measure, communicate and manage our risks within established limits and risk tolerances.

Our Board of Directors and senior management are knowledgeable of and accountable for key risks. Our Board meets at least quarterly and regularly hears reports from the Chief Executive Officer, the business unit Presidents, the Chief Financial Officer and the Chief Investment Officer. The Board has several committees, which include the Audit Committee, the Human Resources Committee and the Nominating and Governance Committee that meet at least quarterly and address various aspects of risks. In addition, the Board of Directors and senior management receive quarterly updates from the Chief Risk Officer.

We also have several senior management groups and committees that meet on a regular and frequent basis to discuss various issues and risks associated with our businesses. These committees encompass numerous functions such as discussing and setting business unit and company strategy, reviewing and approving potential uses of corporate capital and setting investment policy and reviewing its implementation. Many key members of senior management serve on multiple committees, allowing them to provide oversight and take a holistic view of our key risks.

Our enterprise risk management program is executed via a federated model. The Chief Risk Officer and the corporate risk units are independent of the business units, and work closely with the business units, providing oversight and integration of all risk management activities. Each business unit is responsible for identifying, monitoring, measuring and managing its risks, as well as monitoring how its risks impact the enterprise's overall risk exposure. The business units provide risk reports to the Chief Risk Officer quarterly with current risk management information.

We have established risk tolerances from an overall corporate perspective as well as for specific types of risks. All potentially significant actions are considered in terms of the possible impact on our risk profile, including the capital required, the impact on near term and long-term earnings and the ability to meet our targets with respect to return on equity, liquidity, debt/capital, cash coverage and other ratios and metrics. We monitor a variety of risk metrics on an ongoing basis and make any necessary adjustments to help us stay within our established risk tolerances. We have developed a Business Continuity Management Program that identifies critical business functions and includes plans for

their protection and recovery in the event of a disaster or other business interruption. We continually monitor emerging risks, and we regularly build upon our already strong risk management practices to incorporate updated modeling tools,

processes and metrics which we actively use to better understand and manage our business. We monitor three key risk metrics as part of our enterprise risk management framework:

Earnings at Risk, which is a measure of the potential reduction in operating earnings and net income relative to baseline operating earnings and net income under relatively adverse business and economic conditions.

Embedded Value at Risk, which is a measure of the potential reduction in embedded value relative to baseline embedded value under relatively adverse business and economic conditions.

Economic Total Asset Requirement, which is the total assets required to ensure that we can meet all of our obligations with a high degree of confidence. Economic Total Asset Requirement is the sum of Economic Reserves and Economic Capital.

## Employees

As of December 31, 2008, we had 16,234 employees. None of our employees are subject to collective bargaining agreements governing employment with us. We believe that our employee relations are satisfactory.

## Internet Website

Our Internet website can be found at [www.principal.com](http://www.principal.com). We make available free of charge on or through our Internet website, access to our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after such material is filed with or furnished to the SEC. Also available free of charge on our Internet website, and in print to any requesting stockholder, is our code of business conduct and ethics, corporate governance guidelines and charters for the audit, human resources and nominating and governance committees of our Board of Directors. Also see Item 10. "Directors, Executive Officers and Corporate Governance."

## Item 1A. Risk Factors

This section provides an overview of the risks that may impact our performance in the future.

### **Adverse capital and credit market conditions may significantly affect our ability to meet liquidity needs, as well as our access to capital and cost of capital.**

Since mid 2007, the capital and credit markets have been experiencing extreme volatility and disruption. Beginning in the second half of 2008, the volatility and disruption have reached unprecedented levels and the markets have exerted downward pressure on availability of liquidity and credit capacity for certain issuers. For example, recently credit spreads have widened considerably. Our results of operations, financial condition, cash flows and statutory capital position could be materially adversely affected by continued disruptions in the capital and credit markets.

We maintain a level of cash and securities which, combined with expected cash inflows from investments and operations, is believed adequate to meet anticipated short-term and long-term benefit and expense payment obligations. However, withdrawal and surrender levels may differ from anticipated levels for a variety of reasons, such as changes in economic conditions or changes in our claims paying ability and financial strength ratings. For additional information regarding our exposure to interest rate risk and the impact of a downgrade in our financial strength ratings, see "Changes in interest rates or credit spreads may adversely affect our results of operations, financial condition and liquidity, and our net investment income can vary from period-to-period" and "A downgrade in our financial strength or credit ratings may increase policy surrenders and withdrawals, reduce new sales and terminate relationships with distributors, impact existing liabilities and increase our cost of capital, any of which could adversely affect our profitability and financial condition." In the event our current internal sources of liquidity do not satisfy our needs, we may have to seek additional financing and, in such case, we may not be able to successfully obtain additional financing on favorable terms, or at all. The availability of additional financing will depend on a variety of factors such as market conditions, the general availability of credit, the volume of trading activities, the overall availability of credit to the financial services industry, our credit ratings and credit capacity, as well as customers' or lenders' perception of our long- or short-term financial prospects. Similarly, our access to funds may be impaired if regulatory authorities or rating agencies take negative actions against us.

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With the uncertainty surrounding the length and severity of the current global recession, we believe it is prudent capital management to continue to explore any and all options available to us to maximize capital flexibility, including accessing the capital markets, utilizing our commercial paper program, cost cutting and internal efficiency initiatives, U.S. government sources of funding and transactions with strategic and other investors. Disruptions, uncertainty or volatility in the capital and credit markets may also limit our access to capital required to operate our business, most significantly our insurance operations. Such market conditions may limit our ability to replace, in a timely manner, maturing liabilities; satisfy statutory capital requirements; fund redemption requests on insurance or other financial products; generate fee income and market-related revenue to meet liquidity needs and access the capital necessary to grow our business. As such, we may be forced to delay raising capital, issue shorter tenor securities than we prefer, utilize available internal resources or bear an unattractive cost of capital which could decrease our profitability and significantly reduce our financial flexibility and liquidity. We will closely monitor market opportunities to issue securities at favorable terms, explore other capital raising transactions, and continue to follow developments of government programs.

For further discussion on liquidity risk management, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources."

**Difficult conditions in the global capital markets and the economy generally may materially adversely affect our business and results of operations and we do not expect these conditions to improve in the near future.**

Our results of operations are materially affected by conditions in the global capital markets and the economy generally, both in the U.S. and elsewhere around the world. The stress experienced by global capital markets that began in the second half of 2007 continued and substantially increased during 2008. Recently, concerns over the availability and cost of credit, the U.S. mortgage market, a declining real estate market in the U.S., inflation, energy costs and geopolitical issues have contributed to increased volatility and diminished expectations for the economy and the markets going forward. These factors, combined with volatile oil prices, declining business and consumer confidence and increased unemployment, have precipitated a recession. In addition, the fixed-income markets are experiencing a period of extreme volatility which has negatively impacted market liquidity conditions. Initially, the concerns on the part of market participants were focused on the subprime segment of the mortgage-backed securities market. However, these concerns have since expanded to include a broad range of mortgage- and asset-backed and other fixed income securities, including those rated investment grade, the U.S. and international credit and interbank money markets, generally, and a wide range of financial institutions and markets, asset classes and sectors. As a result, the market for fixed income instruments has experienced decreased liquidity, increased price volatility, credit downgrade events and increased probability of default. Securities that are less liquid are more difficult to value and may be hard to dispose of. These events and the continuing market upheavals have had and may continue to have an adverse effect on the value of our investment portfolio. Our AUM and revenues may decline in such circumstances and our profit margins could erode. In addition, in the event of extreme prolonged market events, such as the global credit crisis, we could incur significant losses. Even in the absence of a market downturn, we are exposed to substantial risk of loss due to market volatility.

Factors such as consumer spending, business investment, government spending, the volatility and strength of the capital markets, investor and consumer confidence and inflation all affect the business and economic environment and, ultimately, the amount and profitability of our business. In an economic downturn characterized by higher unemployment, lower family income, lower corporate earnings, lower business investment, negative investor sentiment and lower consumer spending, the demand for our financial and insurance products could be adversely affected. In addition, we may experience an elevated incidence of claims and lapses or surrenders of policies. Our policyholders may choose to defer paying insurance premiums or stop paying insurance premiums altogether. In addition, participants within the retirement plans we administer may elect to reduce or stop their payroll deferrals to these plans, which would reduce AUM and revenues. Adverse changes in the economy could affect net income negatively and could have a material adverse effect on our business, results of operations and financial condition.

**Continued declines and volatility in the equity markets could reduce our AUM and may result in investors withdrawing from the markets or decreasing their rates of investment, all of which could reduce our revenues and net income.**

Domestic and international equity markets have been experiencing severe declines and heightened volatility. Because the revenues of our asset management and accumulation business are, to a large extent, based on the value of AUM, a decline in domestic and global equity markets will decrease our revenues. Turmoil in these markets could lead investors to withdraw from these markets, decrease their rates of investment or refrain from making new investments which may reduce our net income, revenues and AUM.

For further discussion on equity risk management, see Item 7A. "Quantitative and Qualitative Disclosures About Market Risk Equity Risk."

**There can be no assurance that actions of the U.S. government, Federal Reserve and other governmental and regulatory bodies for the purpose of stabilizing the financial markets will achieve the intended effect.**

In response to the financial crisis affecting the banking system, financial markets, investment banks and other financial institutions, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law. Pursuant to the EESA, the U.S. Treasury has the authority to, among other things, make equity investments in certain financial institutions and purchase mortgage-backed and other securities from financial institutions for an aggregate amount of up to \$700.0 billion. As a savings and loan holding company subject to oversight of the Office of Thrift Supervision, we have applied to participate in the U.S. Department of the Treasury's Capital Purchase Program ("TCPP"). If we participate in TCPP, we would issue preferred shares and warrants to the Treasury. The amount for which a company can apply is prescribed by the TCPP application. We have applied for and could participate in up to \$2.0 billion under the program. If we were to participate in the TCPP, we would be subject to certain limitations. Prior to the third anniversary of our participation, unless we had redeemed all of the preferred stock issued under the TCPP or the U.S. Treasury had transferred all of the preferred stock to a third party, the consent of the U.S. Treasury would be required for us to, among other things, increase our common stock dividend or repurchase our common stock or other preferred stock (with certain exceptions, including the repurchase of our common stock to offset share dilution from equity-based employee compensation awards).



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The federal government, Federal Reserve and other governmental and regulatory bodies have taken and, in light of the continuing economic crisis, are considering taking other actions to address the financial crisis, including future investments in other financial institutions. There can be no assurance as to what impact such actions will have on the financial markets, including the extreme levels of volatility currently being experienced. Such continued volatility could materially and adversely affect our business, financial condition and results of operations, or the trading price of our common stock.

### **Our participation in a securities lending program may subject us to potential liquidity and other risks.**

We have previously participated in a securities lending program for our general account whereby primarily fixed income securities were loaned by us to third parties, primarily major brokerage firms and commercial banks. The borrowers of our securities provided us with cash collateral, which we separately maintained. We invested such cash collateral in other securities, primarily U.S. Treasuries, U.S. government agency securities, U.S. government agency collateralized repurchase agreements and government money market funds. During the third quarter of 2008, we decided to temporarily unwind the securities lending program due to a downturn in current economic conditions. As of December 31, 2008, we did not have any general account securities on loan, nor was the general account liable for any cash collateral.

We may consider resuming our general account securities lending program when and if market conditions improve in the future. If we choose to resume the program in the future, we may be exposed to liquidity and other risks associated with securities lending.

### **Changes in interest rates or credit spreads may adversely affect our results of operations, financial condition and liquidity, and our net income can vary from period-to-period.**

We are exposed to significant financial and capital markets risk, including changes in interest rates, credit spreads, equity prices, real estate values, foreign currency exchange rates, market volatility, the performance of the economy in general, the performance of the specific obligors included in our portfolio and other factors outside our control. Our exposure to interest rate risk relates primarily to the market price and cash flow variability associated with changes in interest rates. A rise in interest rates will increase the net unrealized loss position of our investment portfolio and, if long-term interest rates rise dramatically within a six to twelve month time period, certain of our life insurance and annuities businesses may be exposed to disintermediation risk. Disintermediation risk refers to the risk that our policyholders may surrender their contracts in a rising interest rate environment, requiring us to liquidate assets in an unrealized loss position. Due to the long-term nature of the liabilities associated with certain of our life insurance businesses, sustained declines in long-term interest rates may subject us to reinvestment risks and increased hedging costs. In other situations, declines in interest rates may result in increasing the duration of certain life insurance liabilities, creating asset and liability duration mismatches.

Our investment portfolio also contains interest rate sensitive instruments, such as fixed income securities, which may be adversely affected by changes in interest rates from governmental monetary policies, domestic and international economic and political conditions and other factors beyond our control. A rise in interest rates would increase the net unrealized loss position of our investment portfolio, offset by our ability to earn higher rates of return on funds reinvested. Conversely, a decline in interest rates would decrease the net unrealized loss position of our investment portfolio, offset by lower rates of return on funds reinvested. Although we take measures to manage the economic risks of investing in a changing interest rate environment, we may not be able to mitigate the interest rate risk of our assets relative to our liabilities.

Our exposure to credit spreads primarily relates to market price variability and reinvestment risk associated with changes in credit spreads. A widening of credit spreads will increase the net unrealized loss position of the investment portfolio, will increase losses associated with credit-based derivatives that do not qualify or have not been designated for hedge accounting where we assume credit exposure and, if issuer credit spreads increase as a result of fundamental credit deterioration, would likely result in higher other-than-temporary impairments. Credit spread tightening will reduce net investment income associated with new purchases of fixed maturities. Credit spread tightening may also cause an increase in the reported value of certain liabilities that are valued using a discount rate that reflects our own credit spread. In addition, market volatility may make it difficult to value certain of our securities if trading becomes less frequent. As such, valuations may include assumptions or estimates that may have significant period-to-period changes, which could have a material adverse effect on our results of operations or financial condition. Recent credit spreads on both corporate and structured securities have widened, resulting in continuing depressed pricing. Continuing challenges include continued weakness in the U.S. residential real estate market and increased mortgage delinquencies, investor anxiety over the U.S. economy, rating agency downgrades of various structured products and financial issuers, unresolved issues with structured investment vehicles and monolines, deleveraging of financial institutions and hedge funds and a serious dislocation in the inter-bank market. If significant, continued volatility, changes in interest rates, changes in credit spreads and defaults, a lack of pricing transparency, market liquidity, declines in equity prices, declines in inflation-adjusted investments and the strengthening or weakening of foreign currencies against the U.S. dollar, individually or in tandem,

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could continue to have a material adverse effect on our results of operations, financial condition or cash flows through realized losses, impairments and changes in unrealized positions.

**Our investment portfolio is subject to several risks that may diminish the value of our invested assets and the investment returns credited to customers, which could reduce our sales, revenues, AUM and net income.**

***An increase in defaults or write-downs on our fixed maturity securities portfolio may reduce our profitability.***

We are subject to the risk that the issuers of the fixed maturity securities we own will default on principal and interest payments, particularly if a major downturn in economic activity occurs. As of December 31, 2008, our U.S. investment operations held \$38.8 billion of fixed maturity securities, or 70% of total U.S. invested assets, of which approximately 5.2% were below investment grade, including \$252.1 million, or 0.65% of our total fixed maturity securities which we classified as either "problem," "potential problem" or "restructured." See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Investments U.S. Investment Operations Fixed Maturity Securities."

Our U.S. fixed maturity securities portfolio includes securities collateralized by residential and commercial mortgage loans. As of December 31, 2008, our U.S. investment operations held \$6.6 billion of mortgage-backed securities, or 17% of our total fixed maturity securities portfolio. Changes in mortgage delinquency or recovery rates, credit rating changes by rating agencies, bond insurer strength or rating, and the quality of service provided by service providers on securities in our portfolios could lead to write-downs on these securities. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Investments U.S. Investment Operations Fixed Maturity Securities."

As of December 31, 2008, the international investment operations of our fully consolidated subsidiaries held \$2.1 billion, or 64%, of total international invested assets in fixed maturity securities, of which 18% are government bonds. Some non-government bonds have been rated on the basis of the issuer's country credit rating. However, the ratings relationship between national ratings and global ratings is not linear with the U.S. The starting point for national ratings differs by country, which makes the assessment of credit quality more difficult. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Investments International Investment Operations." An increase in defaults on our fixed maturity securities portfolio could harm our financial strength and reduce our profitability.

***An increased rate of delinquency and defaults on our commercial mortgage loans, especially those with amortizing balloon payments, may adversely affect our profitability.***

Our commercial mortgage loan portfolio faces both delinquency and default risk. Commercial mortgage loans of \$11.3 billion represented 19% of our total invested assets as of December 31, 2008. As of December 31, 2008, loans that were in the process of foreclosure totaled \$26.0 million, or 0.2% of our commercial mortgage loan portfolio. The performance of our commercial mortgage loan investments, however, may fluctuate in the future. An increase in the delinquency rate of, and defaults under, our commercial mortgage loan portfolio could harm our financial strength and decrease our profitability.

As of December 31, 2008, approximately \$9.5 billion, or 83%, of our commercial mortgage loans before valuation allowance had amortizing balloon payment maturities. A balloon maturity is a loan with larger dollar amounts of payments becoming due in the later years of the loan. The default rate on commercial mortgage loans with balloon payment maturities has historically been higher than for commercial mortgage loans with standard repayment schedules. Since most of the principal is repaid at maturity, the amount of loss on a default is generally greater than on other commercial mortgage loans. An increase in defaults on such loans as a result of the foregoing factors could harm our financial strength and decrease our profitability.

***We may have difficulty selling our privately placed fixed maturity securities, commercial mortgage loans and real estate investments because they are less liquid than our publicly traded fixed maturity securities and because they have been experiencing significant market valuation fluctuations.***

We hold certain investments that may lack liquidity, such as privately placed fixed maturity securities, commercial mortgage loans and real estate investments. These asset classes represented approximately 41% of the value of our invested assets as of December 31, 2008. Even some of our very high quality assets have been more illiquid as a result of the recent challenging market conditions.

If we require significant amounts of cash on short notice, we may have difficulty selling these investments in a timely manner, be forced to sell them for less than we otherwise would have been able to realize or both. The reported value of our relatively illiquid types of investments, our investments in the asset classes described above and, at times, our high quality, generally liquid asset classes, do not necessarily reflect the lowest possible price for the asset. If we were forced to sell certain of our assets in the current market, there can be no assurance that we will be able to sell them for the prices at which we have recorded them and we may be forced to sell them at significantly lower prices.



***The impairment of other financial institutions could adversely affect us.***

We use derivative instruments to hedge various risks we face in our businesses. See Item 7A. "Quantitative and Qualitative Disclosures About Market Risk." We enter into a variety of derivative instruments, including interest rate swaps, swaptions, futures, currency swaps, currency forwards, credit default swaps, treasury lock agreements, commodity swaps and options, with a number of counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks and other investment funds and other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty. If our counterparties fail to honor their obligations under the derivative instruments, we will have failed to effectively hedge the related risk. In addition, with respect to secured transactions, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure due to it. We also have exposure to these financial institutions in the form of unsecured debt instruments and equity investments. Such losses or impairments to the carrying value of these assets may materially and adversely affect our business and results of operations.

***Our requirements to post collateral or make payments related to declines in market value of specified assets may adversely affect our liquidity and expose us to counterparty credit risk.***

Many of our derivative transactions with financial and other institutions specify the circumstances under which the parties are required to post collateral. The amount of collateral we may be required to post under these agreements may increase under certain circumstances, which could adversely affect our liquidity. In addition, under the terms of some of our transactions we may be required to make payment to our counterparties related to any decline in the market value of the specified assets. Such payments could have an adverse effect on our liquidity. Furthermore, with respect to any such payments, we will have unsecured risk to the counterparty as these amounts are not required to be segregated from the counterparty's other funds, are not held in a third-party custodial account, and are not required to be paid to us by the counterparty until the termination of the transaction.

***Environmental liability exposure may result from our commercial mortgage loan portfolio and real estate investments.***

Liability under environmental protection laws resulting from our commercial mortgage loan portfolio and real estate investments may harm our financial strength and reduce our profitability. Under the laws of several states, contamination of a property may give rise to a lien on the property to secure recovery of the costs of cleanup. In some states, this kind of lien has priority over the lien of an existing mortgage against the property, which would impair our ability to foreclose on that property should the related loan be in default. In addition, under the laws of some states and under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980, we may be liable for costs of addressing releases or threatened releases of hazardous substances that require remedy at a property securing a mortgage loan held by us, if our agents or employees have become sufficiently involved in the hazardous waste aspects of the operations of the related obligor on that loan, regardless of whether or not the environmental damage or threat was caused by the obligor. We also may face this liability after foreclosing on a property securing a mortgage loan held by us. This may harm our financial strength and decrease our profitability.

***Regional concentration of our commercial mortgage loan portfolio in California may subject us to economic downturns or losses attributable to earthquakes in that state.***

Credit extensions in the state of California accounted for 20%, or \$2.2 billion, of our commercial mortgage loan portfolio as of December 31, 2008. Due to this concentration of commercial mortgage loans in California, we are exposed to potential losses resulting from the risk of an economic downturn in California as well as to catastrophes, such as earthquakes, that may affect the region. While we generally do not require earthquake insurance for properties on which we make commercial mortgage loans, we do take into account property specific engineering reports, construction type and geographical concentration by fault lines in our investment underwriting guidelines. If economic conditions in California do not improve or continue to deteriorate or catastrophes occur, we may in the future, experience delinquencies or defaults on the portion of our commercial mortgage loan portfolio located in California, which may harm our financial strength and reduce our profitability.

***Our valuation of fixed maturity and equity securities may include methodologies, estimations and assumptions which are subject to differing interpretations and could result in changes to investment valuations that may materially adversely affect our results of operations or financial condition.***

Fixed maturity securities, equity securities and short-term investments which are reported at fair value on our consolidated statements of financial position represented the majority of our total cash and invested assets. Statement of Financial Accounting Standard ("SFAS") No. 157, *Fair Value Measurements* ("SFAS 157"), establishes a three-level hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The level in the fair value hierarchy is based on the priority of the inputs to the respective valuation technique. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to



unobservable inputs (Level 3). An asset or liability's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation.

Level 1: Fair values are based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2: Fair values are based on inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3: Fair values are based on at least one significant unobservable input for the asset or liability.

At December 31, 2008, approximately 32%, 61% and 7% of our net assets and liabilities reported at fair value represented Level 1, Level 2 and Level 3, respectively. Our Level 1 assets and liabilities primarily include exchange traded equity securities, mutual funds and U.S. Treasury bonds. Our Level 2 assets and liabilities primarily include fixed maturity securities (including public and private bonds), equity securities, over-the-counter derivatives and other investments for which public quotations are not available but that are priced by third-party pricing services or internal models using observable inputs. Our Level 3 assets and liabilities include certain fixed maturity securities, private equity securities, complex derivatives and embedded derivatives. Level 3 securities contain at least one significant unobservable market input and as a result considerable judgment may be used in determining the fair values. These fair values are generally obtained through the use of valuation models or methodologies using at least one significant unobservable input or broker quotes. Prices provided by independent pricing services or independent broker quotes that are used in the determination of fair value can vary for a particular security.

For additional information on our valuation methodology, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 17, Fair Value of Financial Instruments."

During periods of market disruption including periods of significantly rising or high interest rates, rapidly widening credit spreads or illiquidity, it may be difficult to value certain of our securities, for example collateralized mortgage obligations and collateralized debt obligations, if trading becomes less frequent and/or market data becomes less observable. There may be certain asset classes that were in active markets with significant observable data that become illiquid due to the current financial environment. In such cases, more securities may fall to Level 3 and thus require more subjectivity and management judgment. As such, valuations may include inputs and assumptions that are less observable or require greater estimation as well as valuation methods that require greater estimation, which could result in values that are different from the value at which the investments may be ultimately sold. Further, rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within our consolidated financial statements and the period-to-period changes in value could vary significantly. Decreases in value may have a material adverse effect on our results of operations or financial condition.

**The determination of the amount of allowances and impairments taken on our investments is highly subjective and could materially impact our results of operations or financial position.**

The determination of the amount of allowances and impairments vary by investment type and is based upon our monthly evaluation and assessment of known and inherent risks associated with the respective asset class. Such evaluations and assessments are revised as conditions change and new information becomes available. There can be no assurance that our management has accurately assessed the level of impairments taken and allowances reflected in our financial statements. Furthermore, additional impairments may need to be taken or allowances provided for in the future. Historical trends may not be indicative of future impairments or allowances.

Additionally, our management considers a wide range of factors about the security issuer and uses their best judgment in evaluating the cause of the decline in the estimated fair value of the security and in assessing the prospects for recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. For further information regarding our impairment methodology, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Investments U.S. Investment Operations Fixed Maturity Securities."

**Gross unrealized losses may be realized or result in future impairments, resulting in a reduction in our net income.**

Fixed maturity securities that are classified as available-for-sale ("AFS") are reported on the consolidated statements of financial position at fair value. Unrealized gains or losses on AFS securities are recognized as a component of equity and are, therefore, excluded from net income. Our U.S. investment operations held gross unrealized losses on fixed maturity securities of \$8.2 billion pre-tax as of December 31, 2008, and the

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component of gross unrealized losses for securities trading down 20% or more for over six months was approximately \$1.8 billion pre-tax. The accumulated change in fair value of the AFS securities is recognized in net income when the gain or loss is realized upon the sale of the asset or in the event that the decline in fair value is determined to be other than temporary (referred to as an other-than-temporary impairment). Realized losses or impairments may have a material adverse impact on our net income in a particular quarter or annual period.

**Competition from companies that may have greater financial resources, broader arrays of products, higher ratings and stronger financial performance may impair our ability to retain existing customers, attract new customers and maintain our profitability.**

We believe that our ability to compete is based on a number of factors including scale, service, product features, price, investment performance, commission structure, distribution capacity, financial strength ratings and name recognition. We compete with a large number of financial services companies such as banks, mutual funds, broker-dealers, insurers and asset managers, many of which have advantages over us in one or more of the above competitive factors.

Each of our segments faces strong competition. The primary competitors for our U.S. Asset Accumulation and Global Asset Management segments are asset managers, banks, broker-dealers and insurers. Our ability to increase and retain AUM is directly related to the performance of our investments as measured against market averages and the performance of our competitors. Even when securities prices are generally rising, performance can be affected by investment styles. Also, there is a risk that we may not be able to attract and retain the top talent needed to compete in our industry.

Competition for our International Asset Management and Accumulation segment comes primarily from local financial services firms and other international companies operating on a stand-alone basis or in partnership with local firms.

Our Life and Health Insurance segment competes with insurers and managed health care organizations.

National banks, with their large existing customer bases, may increasingly compete with insurers as a result of court rulings allowing national banks to sell annuity products in some circumstances, and as a result of legislation removing restrictions on bank affiliations with insurers. Specifically, the Gramm-Leach-Bliley Act of 1999 permits mergers that combine commercial banks, insurers and securities firms under one holding company. These developments may increase competition, in particular for our asset management and accumulation businesses, by substantially increasing the number, size and financial strength of potential competitors who may be able to offer, due to economies of scale, more competitive pricing than we can.

In response to current market conditions, the U.S. and foreign governments in the markets we serve have taken actions, including but not limited to, direct government control or investment in certain entities. We may find that these actions create, among other things, unforeseen competitive advantages for our competitors due to explicit or implied support from the government.

**A downgrade in our financial strength or credit ratings may increase policy surrenders and withdrawals, reduce new sales and terminate relationships with distributors, impact existing liabilities and increase our cost of capital, any of which could adversely affect our profitability and financial condition.**

Nationally Recognized Statistical Rating Organizations ("NRSROs") publish financial strength ratings on U.S. life insurance companies that are indicators of an insurance company's ability to meet contractholder and policyholder obligations. NRSROs also assign credit ratings on non-life insurance entities, such as PFG and Principal Financial Services, Inc. ("PFS"). Credit ratings are indicators of a debt issuer's ability to meet the terms of debt obligations in a timely manner, and are important factors in overall funding profile and ability to access external capital.

Ratings are important factors in establishing the competitive position of insurance companies and maintaining public confidence in products being offered. A ratings downgrade, or the potential for such a downgrade, could, among other things:

materially increase the number of surrenders for all or a portion of the net cash values by the owners of policies, contracts, general account GICs we have issued, and materially increase the number of withdrawals by policyholders of cash values from their policies;

result in the termination of our relationships with broker-dealers, banks, agents, wholesalers and other distributors of our products and services;

reduce new sales, particularly with respect to general account GICs and funding agreements purchased by pension plans and other institutions;

cause some of our existing liabilities to be subject to acceleration, additional collateral support, changes in terms, or creation of additional financial obligations and



increase our cost of capital and limit our access to the capital markets.

Any of these consequences could adversely affect our profitability and financial condition.

In recent months, each of A.M. Best Company, Inc., Fitch Ratings Ltd., Moody's Investors Service, and Standard & Poor's has revised its outlook for the U.S. life insurance industry to negative from stable. Of the many issues cited, the

negative outlook is primarily based on expectations for higher-than-normal credit losses, negative impact of the volatile equity market on earnings, and reduced financial flexibility.

These outlook revisions signal increased review of U.S. life insurance companies by A.M. Best Company, Inc., Fitch Ratings, Ltd., Moody's Investors Service, and Standard & Poor's. As a result, it is possible that there will be changes in the benchmarks for capital, liquidity, earnings and other factors used by these NRSROs that are critical to a ratings assignment at a particular rating level. If any such changes are made, it is possible that such changes could have an impact on the ratings of U.S. life insurance companies, including ours, which could adversely impact our profitability and financial condition.

**Our efforts to reduce the impact of interest rate changes on our profitability and retained earnings may not be effective.**

We attempt to significantly reduce the impact of changes in interest rates on the profitability and retained earnings of our asset accumulation and life and health insurance operations. We accomplish this reduction primarily by managing the duration of our assets relative to the duration of our liabilities. During a period of rising interest rates, policy surrenders, withdrawals and requests for policy loans may increase as customers seek to achieve higher returns. Despite our efforts to reduce the impact of rising interest rates, we may be required to sell assets to raise the cash necessary to respond to such surrenders, withdrawals and loans, thereby realizing capital losses on the assets sold. Liquidations may result in capital losses, particularly in periods of volatile interest rates and credit spreads. Because volatile interest rates and credit spreads often make it more difficult to sell certain fixed income securities, there is also a risk that we will find it difficult to raise the cash necessary to fund a very large amount of withdrawal activity. An increase in policy surrenders and withdrawals may also require us to accelerate amortization of deferred policy acquisition costs ("DPAC") relating to these contracts, which would further reduce our profitability.

During periods of declining interest rates, borrowers may prepay or redeem mortgages and bonds that we own, which would force us to reinvest the proceeds at lower interest rates. For some of our products, such as GICs and funding agreements, we are unable to lower the rate we credit to customers in response to the lower return we will earn on our investments. In addition, it may be more difficult for us to maintain our desired spread between the investment income we earn and the interest we credit to our customers during periods of declining interest rates, thereby reducing our profitability.

For further discussion on interest rate risk management, see Item 7A. "Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk."

**If we are unable to attract and retain sales representatives and develop new distribution sources, sales of our products and services may be reduced.**

We distribute our asset accumulation, asset management and life, health and specialty benefit insurance products and services through a variety of distribution channels, including our own internal sales representatives, independent brokers, banks, broker-dealers and other third-party marketing organizations. We must attract and retain sales representatives to sell our products. Strong competition exists among financial services companies for efficient sales representatives. We compete with other financial services companies for sales representatives primarily on the basis of our financial position, support services and compensation and product features. If we are unable to attract and retain sufficient sales representatives to sell our products, our ability to compete and revenues from new sales would suffer.

**Our international businesses face political, legal, operational and other risks that could reduce our profitability in those businesses.**

Our international businesses are subject to comprehensive regulation and supervision from central and/or local governmental authorities in each country in which we operate. New interpretations of existing laws and regulations or the adoption of new laws and regulations may harm our international businesses and reduce our profitability in those businesses.

Our international businesses face political, legal, operational and other risks that we do not face in our operations in the U.S. We face the risk of discriminatory regulation, nationalization or expropriation of assets, price controls and exchange controls or other restrictions that prevent us from transferring funds from these operations out of the countries in which they operate or converting local currencies we hold into U.S. dollars or other currencies. Some of our international businesses are, and are likely to continue to be, in emerging or potentially volatile markets. In addition, we rely on local staff, including local sales forces, in these countries where there is a risk that we may encounter labor problems with local staff, especially in countries where workers' associations and trade unions are strong. If our business model, including in some cases a joint venture model, is not successful in a particular country, we may lose all or most of our investment in that country.

**We may face losses if our actual experience differs significantly from our pricing and reserving assumptions.**

Our profitability depends significantly upon the extent to which our actual experience is consistent with the assumptions used in setting prices for our products and establishing liabilities for future insurance and annuity policy benefits and claims. The premiums that we charge and the liabilities that we hold for future policy benefits are based on assumptions concerning a number of factors, including the amount of premiums that we will receive in the future, rate of return on assets we purchase with premiums received, expected claims, mortality, morbidity, expenses and persistency, which is the measurement of the percentage of insurance policies remaining in force from year to year. However, due to the nature of the underlying risks and the high degree of uncertainty associated with the determination of the liabilities for unpaid policy benefits and claims, we cannot determine precisely the amounts we will ultimately pay to settle these liabilities. As a result, we may experience volatility in the level of our profitability and our reserves from period-to-period, particularly for our health and disability insurance products. To the extent that actual experience is less favorable than our underlying assumptions, we could be required to increase our liabilities, which may harm our financial strength and reduce our profitability.

For example, if mortality rates are higher than our pricing assumptions, we will be required to make greater claims payments on our life insurance policies than we had projected. However, this risk is partially offset by our payout annuity business, where an increase in mortality rates will result in a decrease in benefit payments. Our operating earnings may also be adversely impacted by an increase in morbidity rates.

Our operating earnings may also be adversely impacted if our actual investment earnings differ from our pricing and reserve assumptions. Changes in economic conditions may lead to changes in market interest rates or changes in our investment strategies, either of which could cause our actual investment earnings to differ from our pricing and reserve assumptions.

For additional information on our insurance reserves, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates Insurance Reserves".

**Our ability to pay stockholder dividends and meet our obligations may be constrained by the limitations on dividends Iowa insurance laws impose on Principal Life.**

We are an insurance holding company whose assets include all of the outstanding shares of the common stock of Principal Life and other subsidiaries. Our ability to pay dividends to our stockholders and meet our obligations, including paying operating expenses and any debt service, depends upon the receipt of dividends from Principal Life. Iowa insurance laws impose limitations on the ability of Principal Life to pay dividends to us. Any inability of Principal Life to pay dividends to us in the future may cause us to be unable to pay dividends to our stockholders and meet our other obligations. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources" for a discussion of regulatory restrictions on Principal Life's ability to pay us dividends.

**The pattern of amortizing our DPAC and other actuarial balances on our investment contract, participating life insurance and universal life-type products may change, impacting both the level of the asset and the timing of our net income.**

Amortization of the DPAC asset depends on the actual and expected profits generated by the lines of business that incurred the expenses. Expected profits are dependent on assumptions regarding a number of factors including investment returns, benefit payments, expenses, mortality and policy lapse. Due to the uncertainty associated with establishing these assumptions, we cannot, with precision, determine the exact pattern of profit emergence. As a result, amortization of DPAC will vary from period-to-period. To the extent that actual experience emerges less favorably than expected, or our expectation for future profits decreases, the DPAC asset may be reduced, reducing our profitability in the current period.

For additional information, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operation Critical Accounting Policies and Estimates Deferred Policy Acquisition Costs and Other Actuarial Balances."

**We may need to fund deficiencies in our Closed Block assets.**

In connection with its conversion in 1998 into a stock life insurance company, Principal Life established an accounting mechanism, known as a "Closed Block" for the benefit of participating ordinary life insurance policies that had a dividend scale in force on July 1, 1998. Dividend scales are the actuarial formulas used by life insurance companies to determine amounts payable as dividends on participating policies based on experience factors relating to, among other things, investment results, mortality, lapse rates, expenses, premium taxes and policy loan interest and utilization rates. The Closed Block was designed to provide reasonable assurance to policyholders included in the Closed Block that, after the conversion, assets would be available to maintain the aggregate dividend scales in effect for 1997 if the experience underlying such scales were to continue.

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We allocated assets to the Closed Block as of July 1, 1998, in an amount such that we expected their cash flows, together with anticipated revenues from the policies in the Closed Block, to be sufficient to support the Closed Block business, including payment of claims, expenses, charges and taxes and to provide for the continuation of aggregate dividend scales in accordance with the 1997 policy dividend scales if the experience underlying such scales continued, and to allow for appropriate adjustments in such scales if the experience changed. We bear the costs of expenses associated with Closed Block policies and, accordingly, these costs were not funded as part of the assets allocated to the Closed Block. Any increase in such costs in the future will be borne by us. As of December 31, 2008, Closed Block assets and liabilities were \$4,436.4 million and \$5,711.8 million, respectively.

We will continue to pay guaranteed benefits under the policies included in the Closed Block, in accordance with their terms. The Closed Block assets, cash flows generated by the Closed Block assets and anticipated revenues from policies included in the Closed Block may not be sufficient to provide for the benefits guaranteed under these policies. If they are not sufficient, we must fund the shortfall. Even if they are sufficient, we may choose for business reasons to support dividend payments on policies in the Closed Block with our general account funds.

The Closed Block assets, cash flows generated by the Closed Block assets and anticipated revenues from policies in the Closed Block will benefit only the holders of those policies. In addition, to the extent that these amounts are greater than the amounts estimated at the time we funded the Closed Block, dividends payable in respect of the policies included in the Closed Block may be greater than they would have been in the absence of a Closed Block. Any excess net income will be available for distribution over time to Closed Block policyholders but will not be available to our stockholders.

### **A pandemic, terrorist attack or other catastrophic event could adversely affect our net income.**

Our mortality and morbidity experience could be adversely impacted by a catastrophic event. In addition, a severe catastrophic event may cause significant volatility in global financial markets, disruptions to commerce and reduced economic activity. The resulting macroeconomic conditions could adversely affect our cash flows, as well as the value and liquidity of our invested assets. We may also experience operational disruptions if our employees are unable or unwilling to come to work due to a pandemic or other catastrophe. We have developed extensive contingency plans to minimize the risk of operational disruptions. In addition, our use of reinsurance reduces our exposure to adverse mortality experience. Despite these measures, we may still be exposed to losses in the event of a pandemic, terrorist attack or other catastrophe.

### **Our reinsurers could default on their obligations or increase their rates, which could adversely impact our net income and profitability.**

We cede material amounts of insurance to other insurance companies through reinsurance. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 1, Nature of Operations and Significant Accounting Policies." However, we remain liable to the policyholder, even if the reinsurer defaults on its obligations with respect to the ceded business. If a reinsurer fails to meet its obligations, we will be forced to cover the claims on the reinsured policies. In addition, a reinsurer insolvency may cause us to lose our reserve credits on the ceded business, in which case we would be required to establish additional reserves.

The premium rates that we charge are based, in part, on the assumption that reinsurance will be available at a certain cost. Some of our reinsurance contracts contain provisions which limit the reinsurer's ability to increase rates on in-force business; however, some do not. If a reinsurer raises the rates that it charges on a block of in-force business, our profitability may be negatively impacted if we are not able to pass the increased costs on to the customer. If reinsurers raise the rates that they charge on new business, we may be forced to raise the premiums that we charge, which could have a negative impact on our competitive position.

To mitigate the risks associated with the use of reinsurance, we carefully select our reinsurers, and we monitor their ratings and financial condition on a regular basis. We also spread our business among several reinsurers, in order to diversify our risk exposure.

### **We face risks arising from acquisitions of businesses.**

We have engaged in acquisitions of businesses in the past, and expect to continue to do so in the future. We face a number of risks arising from acquisition transactions, including difficulties in integrating the acquired business into our operations, difficulties in assimilating and retaining employees and intermediaries, difficulties in retaining the existing customers of the acquired entity, unforeseen liabilities that arise in connection with the acquired business and unfavorable market conditions that could negatively impact our growth expectations for the acquired business. These risks may prevent us from realizing the expected benefits from acquisitions and could result in the impairment of goodwill and/or intangible assets recognized at the time of acquisition.

For additional information on our goodwill and other intangible assets, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates Goodwill and Other Intangible Assets."

**Changes in laws, regulations or accounting standards may reduce our profitability.**

***Changes in regulations may reduce our profitability.***

Our insurance business is subject to comprehensive state regulation and supervision throughout the U.S and in the international markets in which we operate. We are also impacted by federal legislation and administrative policies in areas such as employee benefit plan regulation, financial services regulations and federal taxation. The primary purpose of state regulation of the insurance business is to protect policyholders, not stockholders. The laws of the various states establish insurance departments with broad powers to regulate such matters as:

licensing companies to transact business,

licensing agents,

admitting statutory assets,

mandating a number of insurance benefits,

regulating premium rates,

approving policy forms,

regulating unfair trade and claims practices,

establishing statutory reserve requirements and solvency standards,

fixing maximum interest rates on life insurance policy loans and minimum rates for accumulation of surrender values,

restricting various transactions between affiliates and

regulating the types, amounts and valuation of investments.

State insurance regulators, federal regulators and the NAIC continually reexamine existing laws and regulations, and may impose changes in the future.

State insurance guaranty associations have the right to assess insurance companies doing business in their state for funds to help pay the obligations of insolvent insurance companies to policyholders and claimants. Because the amount and timing of an assessment is beyond our control, the liabilities we have established for these potential assessments may not be adequate.

Federal legislation and administrative policies in areas such as employee benefit plan regulation, financial services regulation and federal taxation can reduce our profitability. For example, Congress has, from time to time, considered legislation relating to changes in the Employee Retirement Income Security Act of 1974 to permit application of state law remedies, such as consequential and punitive damages, in lawsuits for wrongful denial of benefits, which, if adopted, could increase our liability for damages in future litigation. Additionally, new interpretations of existing laws and the passage of new legislation may harm our ability to sell new policies and increase our claims exposure on policies we issued previously. In addition, reductions in contribution levels to defined contribution plans may decrease our profitability.

***Changes in tax laws could increase our tax costs and reduce sales of our insurance, annuity and investment products.***

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Current federal income tax laws generally permit the tax-deferred accumulation of earnings on the premiums paid by the holders of annuities and life insurance products. Taxes, if any, are payable on income attributable to a distribution under the contract for the year in which the distribution is made. Congress has, from time to time, considered legislation that would reduce or eliminate the benefit of such deferral of taxation on the accretion of value within life insurance and nonqualified annuity contracts. Enactment of this legislation, including a simplified "flat tax" income structure with an exemption from taxation for investment income, could result in fewer sales of our insurance, annuity and investment products.

From time to time, Congress, as well as foreign, state and local governments, considers legislation that could increase our tax costs. If such legislation is adopted, our profitability could be negatively impacted.

***Repeal or modification of the federal estate tax could reduce our revenues.***

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") amended the federal estate tax laws by increasing the amount of the unified credit beginning in 2002, thereby increasing the amount of property not subject to the estate tax. The Act also gradually reduces the federal estate tax rate over a period of years beginning in 2002, and repeals the tax entirely in 2010. The law in effect prior to the Act, however, is reinstated for years after 2010. Through the year ended December 31, 2008, we received recurring premium of \$55.7 million for survivorship life insurance policies we have sold. A significant number of these policies were purchased for the purpose of providing cash to pay federal estate

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taxes. The reduction of the federal estate tax and temporary repeal could result in policyholders reducing coverage under, or surrendering, these policies.

### ***Changes in federal, state and foreign securities laws may reduce our profitability.***

Our asset management and accumulation and life insurance businesses are subject to various levels of regulation under federal, state and foreign securities laws. These laws and regulations are primarily intended to protect investors in the securities markets or investment advisory or brokerage clients and generally grant supervisory agencies broad administrative powers, including the power to limit or restrict the conduct of business for failure to comply with such laws and regulations. The downturn in the financial markets and resulting market-wide losses have caused legislative and regulatory bodies to consider various changes to existing securities laws and the legal framework governing the financial industry. Changes to these laws or regulations that restrict the conduct of our business could significantly increase our compliance costs and reduce our profitability.

### ***Changes in accounting standards may reduce our profitability.***

Accounting standards are subject to change and can negatively impact our profitability. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 1, Nature of Operations and Significant Accounting Policies." In addition to recently issued accounting guidance, the standard setters have a full agenda of topics they plan to review, any of which have the potential to negatively impact our profitability. The results for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period.

### **A computer system failure or security breach could disrupt our business, damage our reputation and adversely impact our profitability.**

We rely on computer systems to conduct business, including customer service, marketing and sales activities, customer relationship management and producing financial statements. While we have policies, procedures, automation and backup plans designed to prevent or limit the effect of failure, our computer systems may be vulnerable to disruptions or breaches as the result of natural disasters, man-made disasters, criminal activity, pandemics, or other events beyond our control. The failure of our computer systems for any reason could disrupt our operations, result in the loss of customer business and adversely impact our profitability.

We retain confidential information on our computer systems, including customer information and proprietary business information. Any compromise of the security of our computer systems that results in the disclosure of personally identifiable customer information could damage our reputation, expose us to litigation, increase regulatory scrutiny and require us to incur significant technical, legal and other expenses.

### **Results of litigation and regulatory investigations may affect our financial strength or reduce our profitability.**

We are a plaintiff or defendant in actions arising out of our insurance businesses and investment operations. We are, from time to time, also involved in various governmental, regulatory and administrative proceedings and inquiries. These factors may affect our financial strength or reduce our profitability. For further discussion on litigation and regulatory investigation risk, see Item 3. "Legal Proceedings."

### **From time to time we may become subject to tax audits, tax litigation or similar proceedings, and as a result we may owe additional taxes, interest and penalties in amounts that may be material.**

We are subject to income taxes in the United States as well as many other jurisdictions. In determining our provisions for income taxes and our accounting for tax-related matters in general, we are required to exercise judgment. We regularly make estimates where the ultimate tax determination is uncertain. We cannot assure you that the final determination of any tax audit, appeal of the decision of a taxing authority, tax litigation or similar proceedings will not be materially different from that reflected in our historical financial statements. The assessment of additional taxes, interest and penalties could be materially adverse to our current and future results of operations and financial condition.

### **Fluctuations in foreign currency exchange rates could reduce our profitability.**

Principal International generally writes policies denominated in various local currencies and invests the premiums and deposits in local currencies. Although investing in local currencies limits the effect of currency exchange rate fluctuation on local operating results, fluctuations in such rates affect the translation of these results into our consolidated financial statements. For further discussion on foreign currency exchange risk, see Item 7A. "Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Risk."

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### **Applicable laws and our stockholder rights plan, certificate of incorporation and by-laws may discourage takeovers and business combinations that our stockholders might consider in their best interests.**

State laws and our certificate of incorporation and by-laws may delay, defer, prevent, or render more difficult a takeover attempt that our stockholders might consider in their best interests. For instance, they may prevent our stockholders from receiving the benefit from any premium to the market price of our common stock offered by a bidder in a takeover context. Even in the absence of a takeover attempt, the existence of these provisions may adversely affect the prevailing market price of our common stock if they are viewed as discouraging takeover attempts in the future.

State laws and our certificate of incorporation and by-laws may also make it difficult for stockholders to replace or remove our management. These provisions may facilitate management entrenchment, which may delay, defer or prevent a change in our control, which may not be in the best interests of our stockholders.

The following provisions, included in our certificate of incorporation and by-laws, may also have anti-takeover effects and may delay, defer or prevent a takeover attempt that our stockholders might consider in their best interests. In particular, our certificate of incorporation and by-laws:

- permit our Board of Directors to issue one or more series of preferred stock;

- divide our Board of Directors into three classes;

- limit the ability of stockholders to remove directors;

- prohibit stockholders from filling vacancies on our Board of Directors;

- prohibit stockholders from calling special meetings of stockholders;

- impose advance notice requirements for stockholder proposals and nominations of directors to be considered at stockholder meetings and

- require the approval by the holders of at least 75% of our outstanding common stock for the amendment of our by-laws and provisions of our certificate of incorporation governing:

  - the classified board,

  - the director's discretion in determining what he or she reasonably believes to be in the best interests of Principal Financial Group, Inc.,

  - the liability of directors and

  - the elimination of the prohibition on stockholder actions by written consent.

In addition, Section 203 of the General Corporation Law of the State of Delaware may limit the ability of an "interested stockholder" to engage in business combinations with us. An interested stockholder is defined to include persons owning 15% or more of our outstanding voting stock.



Our stockholder rights plan may have anti-takeover effects. The stockholder rights plan is designed to protect our stockholders in the event of unsolicited offers to acquire us and other coercive takeover tactics, which, in the opinion of our Board of Directors, could impair the board's ability to represent stockholder interests. Our stockholder rights plan might render an unsolicited takeover more difficult or less likely to occur, even though such a takeover might offer our stockholders the opportunity to sell their stock at a price above the prevailing market price and may be favored by our stockholders.

**Our financial results may be adversely impacted by global climate changes.**

Atmospheric concentrations of carbon dioxide and other greenhouse gases have increased dramatically since the industrial revolution, resulting in a gradual increase in global average temperatures and an increase in the frequency and severity of natural disasters. These trends are expected to continue in the future, and have the potential to impact nearly all sectors of the economy to varying degrees. Our initial research indicates that climate change does not pose an imminent or significant threat to our operations or business, but we will continue to monitor new developments in the future.

Potential impacts may include the following:

Changes in temperatures and air quality may adversely impact our mortality and morbidity rates. For example, increases in the level of pollution and airborne allergens may cause an increase in upper respiratory and cardiovascular diseases, leading to increased claims in our life, health and disability income business. However, the risk of increased mortality on our life insurance business is partly offset by our payout annuity business, where an increase in mortality results in a decrease in benefit payments.

Climate change may impact asset prices, as well as general economic conditions. For example, rising sea levels may lead to decreases in real estate values in coastal areas. Additionally, government policies to slow climate change (e.g., setting limits on carbon emissions) may have an adverse impact on sectors such as utilities, transportation and manufacturing. Changes in asset prices may impact the value of our fixed income, real estate and commercial mortgage investments. We manage our investment risks by maintaining a well-diversified portfolio, both geographically and by sector. We also monitor our investments on an ongoing basis, allowing us to adjust our exposure to sectors and/or geographical areas that face severe risks due to climate change.

A natural disaster that affects one of our office locations could disrupt our operations and pose a threat to the safety of our employees. However, we have extensive Business Continuity and Disaster Recovery planning programs in place to help mitigate this risk.

#### **Item 1B. Unresolved Staff Comments**

None.

#### **Item 2. Properties**

As of December 31, 2008, we own 26 properties in our home office complex in Des Moines, Iowa, and in various other locations. Of these 26 properties, 11 are office buildings, 2 are warehouse facilities, 11 are parking lots and ramps, 1 is a park/green space and 1 is a childcare center. Of the office and warehouse space, we occupy approximately 90% of the 2.8 million square feet of space in these buildings. The balance of the space in these buildings is rented to commercial tenants or is occupied by the property management company servicing these properties. Of the parking properties there are approximately 5,119 stalls, which does not include additional stalls that will be created once construction of a new parking ramp is completed. We lease office space for various offices located throughout the U.S. and internationally. We believe that our owned and leased properties are suitable and adequate for our current business operations.

#### **Item 3. Legal Proceedings**

Disclosure concerning material legal proceedings can be found in Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 15, Contingencies, Guarantees and Indemnifications" under the caption, "Litigation and Regulatory Contingencies," which is incorporated here by this reference.

#### **Item 4. Submission of Matters to a Vote of Security Holders**

No matter was submitted to a vote of our security holders during the fourth quarter of the fiscal year covered by this report.

#### **Executive Officers of the Registrant**

The following information is furnished with respect to our executive officers, each of whom is elected by and serves at the pleasure of the Board of Directors.

**J. Barry Griswell, 59**, has been a Director of the Company since 2001 and of Principal Life since 1998, Chairman of the Board of Directors of the Company and Principal Life since January 1, 2002. Prior to his retirement as an employee of the Company on December 31, 2008, Mr. Griswell was Chairman of the Company and Principal Life since May 2008; Chairman and Chief Executive Officer of the Company and Principal Life from June 2006 until April 2008 and Chairman, President and Chief Executive Officer of the Company and Principal Life from 2002 until May 2006. Mr. Griswell currently serves as President of The Community Foundation of Greater Des Moines. Mr. Griswell is also a director of Herman Miller, Inc., a public company that is an office furnishings designer and manufacturer.

**John E. Aschenbrenner, 59**, who heads the Life and Health Insurance division of our operations, has been President, Insurance and Financial Services, of the Company and of Principal Life since December 2003. Prior to that time, he served as Executive Vice President of the Company since April 2001, and Executive Vice President of Principal Life since January 2000. Mr. Aschenbrenner served as a director of the Principal Funds from September 1998 to September 2006.

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**Michael H. Gersie, 60**, was, until his retirement on December 31, 2008, Executive Vice President of the Company and Principal Life. He served as the Company's Chief Financial Officer from April 2001 until August 2008, and Chief Financial Officer of Principal Life from January 2000 until August 2008.

**Daniel J. Houston, 47**, heads the Retirement and Investor Services division of our operations. He was named President, Retirement and Investor Services of the Company and of Principal Life in February 2008, and was named Executive Vice President, Retirement and Investor Services, in June 2006. He has served as a Senior Vice President of Principal Life since 2000.

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**Ellen Z. Lamale, 55**, has been Senior Vice President and Chief Risk Officer of the Company and Principal Life since May 2008. Prior to that time, she was Senior Vice President and Chief Actuary of the Company since April 2001 and of Principal Life since June 1999.

**Julia M. Lawler, 49**, has been Senior Vice President and Chief Investment Officer of the Company and of Principal Life since July 2002. From 2000 - 2002, she was President of the Real Estate Equity Group of Principal Global Investors, LLC. From 1999 - 2000, she was Vice President Capital Markets.

**Terrance J. Lillis, 56**, has been Senior Vice President and Chief Financial Officer of the Company and of Principal Life since August 2008 and Senior Vice President of the Company and Principal Life since May 2008. Prior to that time, he was Chief Financial Officer Retirement and Investor Services division of Principal Life since December 2001.

**James P. McCaughan, 55**, who heads the Global Asset Management division of our operations, has been President, Global Asset Management of the Company and of Principal Life since December 2003. Prior to that time, he served as Executive Vice President and global head of asset management for the Company and Principal Life since April 2002. From 2000 - 2002, he was Chief Executive Officer of the Americas division of Credit Suisse Asset Management in New York, New York.

**Mary A. O'Keefe, 52**, who heads Corporate Relations and Strategic Development, has been Senior Vice President and Chief Marketing Officer of the Company and Principal Life since February 2005, Senior Vice President of the Company since April 2001, and Senior Vice President of Principal Life since January 1998.

**Gary P. Scholten, 51**, has been Senior Vice President and Chief Information Officer of the Company and Principal Life since November 2002. From 1998 - 2002, he was Vice President of retail information services of Principal Life.

**Karen E. Shaff, 54**, has been Executive Vice President and General Counsel of the Company and of Principal Life since February 2004. Prior thereto, she was Senior Vice President and General Counsel of the Company since April 2001, and Senior Vice President and General Counsel of Principal Life since January 2000.

**Norman R. Sorensen, 63**, has been President of Principal International, Inc. since 1998, Executive Vice President, International Asset Accumulation, of the Company and Principal Life since February 2008, Senior Vice President, International Asset Accumulation of the Company, since April 2001, and Senior Vice President of Principal Life since December 1998.

**Larry D. Zimpleman, 57**, has been a Director of the Company and Principal Life since 2006. He has been Chief Executive Officer and President of the Company and Principal Life since May 2008 and was President and Chief Operating Officer of the Company and Principal Life from 2006 to May 2008. He was President, Retirement and Investor Services of the Company and of Principal Life from December 2003 through May 2006. Mr. Zimpleman served as chairman of the board and a director of the Principal Funds from December 2001 to December 2008.

## PART II

### Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock began trading on the New York Stock Exchange ("NYSE") under the symbol "PFG" on October 23, 2001. Prior to such date, there was no established public trading market for our common stock. On February 11, 2009, there were 458,671 stockholders of record of our common stock.

The following table presents the high and low prices for our common stock on the NYSE for the periods indicated and the dividends declared per share during such periods.

	High	Low	Dividends
<b>2008</b>			
First quarter	\$ 68.94	\$ 47.23	
Second quarter	\$ 59.53	\$ 41.90	
Third quarter	\$ 54.28	\$ 34.80	
Fourth quarter	\$ 45.49	\$ 8.78	\$ 0.45
<b>2007</b>			
First quarter	\$ 64.17	\$ 57.87	
Second quarter	\$ 64.92	\$ 56.56	

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Third quarter		\$63.24	\$51.52	
Fourth quarter		\$70.85	\$60.55	\$ 0.90

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We declared an annual cash dividend of \$0.45 per common share on October 11, 2008, and paid such dividend on December 5, 2008, to stockholders of record on the close of business on November 14, 2008. We declared an annual cash dividend of \$0.90 per common share on October 29, 2007, and paid such dividend on December 7, 2007, to stockholders of record on the close of business on November 16, 2007. Future dividend decisions will be based on and affected by a number of factors, including our operating results and financial requirements and the impact of regulatory restrictions. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources" for a discussion of regulatory restrictions on Principal Life's ability to pay us dividends.

The following table presents the amount of our share purchase activity for the periods indicated:

### Issuer Purchases of Equity Securities

Period		Total Number of Shares (or Units) Purchased(1)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (in millions) (2)
January 1, 2008	January 31, 2008	901,207	\$ 0.03(2)	900,831	\$ 250.0
February 1, 2008	February 29, 2008	102,476	\$ 58.42		\$ 250.0
March 1, 2008	March 31, 2008	881	\$ 55.21		\$ 250.0
April 1, 2008	April 30, 2008	766	\$ 57.07		\$ 250.0
May 1, 2008	May 31, 2008		\$		\$ 250.0
June 1, 2008	June 30, 2008	720	\$ 55.48		\$ 250.0
July 1, 2008	July 31, 2008	2,188	\$ 45.16		\$ 250.0
August 1, 2008	August 31, 2008	3,198	\$ 42.16		\$ 250.0
September 1, 2008	September 30, 2008	759	\$ 45.35		\$ 250.0
October 1, 2008	October 31, 2008	519	\$ 22.61		\$ 250.0
November 1, 2008	November 30, 2008	398	\$ 45.79		\$ 250.0
December 1, 2008	December 31, 2008	434	\$ 13.81		\$ 250.0
<b>Total</b>		<b>1,013,546</b>		<b>900,831</b>	

(1)

The number of shares includes shares of common stock utilized to execute certain stock incentive awards in 2008: 376 shares in January, 102,476 shares in February, 881 shares in March, 766 shares in April, 720 shares in June, 2,188 shares in July, 3,198 shares in August, 759 shares in September, 519 shares in October, 398 shares in November and 434 shares in December.

(2)

During November 2007, our Board of Directors authorized a share repurchase program of up to \$500.0 million of our outstanding common stock. On November 30, 2007, we entered into an accelerated common stock repurchase agreement with a third party investment bank for an aggregate purchase price of \$250.0 million. On this date, we paid \$250.0 million and received the initial delivery of 2.9 million common shares, while retaining the right to receive additional common shares depending on the volume weighted-average price for our common stock over the program's execution period. The program was completed in January 2008, at which time we received 0.9 million additional common shares under this agreement. As of December 31, 2008, \$250.0 million remained under the November 2007 authorization. In the fourth quarter of 2008, we suspended purchases of the remaining \$250.0 million available under the November 2007 authorization.

# Item 6. Selected Financial Data

The following table sets forth certain selected historical consolidated financial information of PFG. We derived the consolidated financial information (except for amounts referred to as "Other Supplemental Data") for each of the years ended December 31, 2008, 2007 and 2006 and as of December 31, 2008 and 2007 from our audited consolidated financial statements and notes to the financial statements included in this Form 10-K. We derived the consolidated financial information (except for amounts referred to as "Other Supplemental Data") for the years ended December 31, 2005 and 2004 and as of December 31, 2006, 2005 and 2004 from our audited consolidated financial statements not included in this Form 10-K. The following summary of consolidated financial information (except for amounts referred to as "Other Supplemental Data") has been prepared in accordance with U.S. GAAP.

In order to fully understand our consolidated financial information, you should also read Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our audited consolidated financial statements and the notes to the financial statements included in this Form 10-K. The results for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period.

	As of or for the year ended December 31,				
	2008(1)	2007(1)	2006(1)	2005	2004
	(\$ in millions, except per share data and as noted)				
Income Statement Data:					
Revenues:					
Premiums and other considerations	\$ 4,209.2	\$ 4,634.1	\$ 4,305.3	\$ 3,975.0	\$ 3,710.0
Fees and other revenues	2,426.5	2,634.7	1,902.5	1,717.8	1,491.7
Net investment income	3,994.3	3,966.5	3,620.6	3,358.0	3,223.6
Net realized capital gains (losses)	(694.1)	(328.8)	44.7	(11.2)	(104.8)
Total revenues	\$ 9,935.9	\$ 10,906.5	\$ 9,873.1	\$ 9,039.6	\$ 8,320.5
Income from continuing operations, net of related income taxes	\$ 458.1	\$ 840.1	\$ 1,035.4	\$ 890.2	\$ 700.6
Income from discontinued operations, net of related income taxes(2)		20.2	28.9	28.8	130.7
Income before cumulative effect of accounting change	458.1	860.3	1,064.3	919.0	831.3
Cumulative effect of accounting change, net of related income taxes					(5.7)
Net income	458.1	860.3	1,064.3	919.0	825.6
Preferred stock dividends(3)	33.0	33.0	33.0	17.7	
Net income available to common stockholders	\$ 425.1	\$ 827.3	\$ 1,031.3	\$ 901.3	\$ 825.6
Earnings per Common Share Data:					
Income from continuing operations, net of related income taxes, per share:					
Basic	\$ 1.64	\$ 3.04	\$ 3.67	\$ 3.03	\$ 2.24
Diluted	\$ 1.63	\$ 3.01	\$ 3.64	\$ 3.01	\$ 2.23
Net income per share:					
Basic	\$ 1.64	\$ 3.12	\$ 3.78	\$ 3.13	\$ 2.64
Diluted	\$ 1.63	\$ 3.09	\$ 3.74	\$ 3.11	\$ 2.62
Common shares outstanding at year-end (in millions)	259.3	259.1	268.4	280.6	300.6
Weighted-average common shares outstanding for the year (in millions)	259.3	265.4	272.9	287.9	313.3
Weighted-average common shares and potential common shares outstanding for the year for computation of diluted earnings per share (in millions)	261.1	268.1	275.5	289.9	314.7
Cash dividends per common share	\$ 0.45	\$ 0.90	\$ 0.80	\$ 0.65	\$ 0.55





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	As of or for the year ended December 31,				
	2008(1)	2007(1)	2006(1)	2005	2004
	(\$ in millions, except as noted)				
<b>Balance Sheet Data:</b>					
Total assets	\$ 128,182.4	\$ 154,520.2	\$ 143,658.1	\$ 127,035.4	\$ 113,798.3
Long-term debt	\$ 1,290.5	\$ 1,398.8	\$ 1,511.3	\$ 855.7	\$ 799.8
Series A preferred stock	\$	\$	\$	\$	\$
Series B preferred stock	0.1	0.1	0.1	0.1	
Common stock	3.9	3.9	3.8	3.8	3.8
Additional paid-in capital	8,376.5	8,295.4	8,141.8	8,000.0	7,269.4
Retained earnings	3,722.5	3,414.3	2,824.1	2,008.6	1,289.5
Accumulated other comprehensive income (loss)	(4,911.6)	420.2	846.9	994.8	1,313.3
Treasury stock, at cost	(4,718.6)	(4,712.2)	(3,955.9)	(3,200.1)	(2,331.7)
Total stockholders' equity	\$ 2,472.8	\$ 7,421.7	\$ 7,860.8	\$ 7,807.2	\$ 7,544.3
<b>Other Supplemental Data:</b>					
AUM (\$ in billions)	\$ 247.0	\$ 311.1	\$ 256.9	\$ 195.2	\$ 167.0
Number of employees (actual)	16,234	16,585	15,289	14,507	13,976

- (1) For a discussion of items materially affecting the comparability of 2008, 2007 and 2006, please see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Transactions Affecting Comparability of Results of Operations."
- (2) See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 3, Discontinued Operations" for a description of our discontinued operations for 2007 and 2006. For each of the years ended December 31, 2005 and 2004, income from discontinued operations related to our sale of Principal Residential Mortgage, Inc. and operating revenues of real estate properties that qualify for discontinued operations treatment. In addition, discontinued operations for the year ended December 31, 2004, includes the impact of the sale of our Argentine companies in 2004.
- (3) On June 16, 2005, we issued 13.0 million shares of non-cumulative perpetual preferred stock. We declared preferred stock dividends of \$33.0 million in 2008, 2007 and 2006 and \$17.7 million in 2005.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following analysis discusses our financial condition as of December 31, 2008, compared with December 31, 2007, and our consolidated results of operations for the years ended December 31, 2008, 2007 and 2006, and, where appropriate, factors that may affect our future financial performance. The discussion should be read in conjunction with our audited consolidated financial statements and the related notes to the financial statements and the other financial information included elsewhere in this Form 10-K.

### Forward-Looking Information

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

Actual results may differ materially from those included in the forward-looking statements as a result of risks and uncertainties. Those risks and uncertainties include, but are not limited to the risk factors listed in Item 1A. "Risk Factors."

### Overview

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

U.S. Asset Accumulation, which consists of our asset accumulation operations that provide retirement savings and related investment products and services. We provide a comprehensive portfolio of asset accumulation products and services to businesses and individuals in the U.S., with a concentration on small and medium-sized businesses. We offer to businesses products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans, nonqualified executive benefit plans and employee stock ownership plan consulting services. We also offer annuities, mutual funds and bank products and services to the employees of our business customers and other individuals.

Global Asset Management, which consists of our asset management operations conducted through Principal Global Investors and its affiliates. Global Asset Management offers an extensive range of equity, fixed income and real estate investments as well as specialized overlay and advisory services to institutional investors.

International Asset Management and Accumulation, which consists of Principal International, offers retirement products and services, annuities, mutual funds, institutional asset management and life insurance accumulation products through operations in Brazil, Chile, China, Hong Kong SAR, India, Indonesia, Malaysia, Mexico and Singapore.

Life and Health Insurance, which provides individual life insurance, group health insurance as well as specialty benefits in the U.S. Our individual life insurance products include universal and variable universal life insurance and traditional life insurance. Our health insurance products include group medical insurance and fee-for-service claims administration and wellness services. Our specialty benefit products include group dental and vision insurance, individual and group disability insurance and group life insurance.

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

### Economic Factors and Trends

The significant decline in the equity markets during 2008, which was partially offset by positive net cash flows, has led to decreases in our U.S. Asset Accumulation segment's account values and our Global Asset Management segment's AUM. Since account values and AUM are the base by which these businesses generate profits, the decline in account values and AUM has put pressure on our profits. In addition, the credit market disruptions in 2008 resulted in an increase in our realized capital losses, which are reflected in net income, and unrealized capital losses,

which are reflected in accumulated other comprehensive income.

In our International Asset Management and Accumulation segment, we continued to grow our business through organic growth in our existing subsidiaries and through new joint ventures and strategic acquisitions. Additionally, the global credit market disruptions, market illiquidity, and foreign currency depreciation during the second half of 2008 resulted in a decrease in our International Asset Management and Accumulation segment's AUM and an increase in our unrealized capital losses, which are reflected in accumulated other comprehensive income.

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In our Life and Health segment, we continue to shift the marketing emphasis of our individual life insurance business to universal life insurance products from traditional life insurance products. In our health insurance and fee-for-service businesses we continue to experience membership declines due to lower sales and higher lapses. Our specialty benefits insurance business is experiencing a slowdown in growth relative to prior years due to a combination of lower sales and higher lapses, as well as reduced growth in salaries and the number of covered lives of our existing customers. This slowdown is a direct reflection of the increasingly competitive marketplace and economic pressures facing our customers.

Given the aforementioned market conditions, and our expectation that these very challenging financial and operating conditions, which have continued into 2009, will not improve significantly in the short term, we have built additional liquidity by increasing cash and cash equivalent holdings. Currently, new cash inflows are primarily being invested in cash, short-term government-backed securities and other liquid investments. As a result of increased cash holdings, current yields will be lower than historically experienced. This trend is expected to continue as long as market conditions remain strained and we continue to invest new cash inflows in cash and liquid investments.

### Profitability

Our profitability depends in large part upon our:

amount of AUM;

spreads we earn on our policyholders' general account asset accumulation business that result from the difference between what we earn and what we credit;

ability to generate fee revenues by providing administrative and investment management services;

ability to price our life and health insurance products at a level that enables us to earn a margin over the cost of providing benefits and the related expenses;

ability to manage our investment portfolio to maximize investment returns and minimize risks such as interest rate changes or defaults or impairments of invested assets;

ability to effectively hedge fluctuations in foreign currency to U.S. dollar exchange rates on certain transactions and

ability to manage our operating expenses.

### Critical Accounting Policies and Estimates

The increasing complexity of the business environment and applicable authoritative accounting guidance requires us to closely monitor our accounting policies. Our significant accounting policies are described in Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 1, Nature of Operations and Significant Accounting Policies." We have identified seven critical accounting policies that are complex and require significant judgment and estimates about matters that are inherently uncertain. A summary of our critical accounting policies is intended to enhance the reader's ability to assess our financial condition and results of operations and the potential volatility due to changes in estimates and changes in guidance. The identification, selection and disclosure of critical accounting estimates and policies have been discussed with the Audit Committee of the Board of Directors.

### *Valuation and Impairment of Fixed Income Investments*

**Fixed Maturities, Available-for-Sale.** Fixed maturity securities include bonds, mortgage-backed securities and redeemable preferred stock. We classify our fixed maturity securities as either available-for-sale or trading and, accordingly, carry them at fair value in the consolidated statements of financial position. The fair values of our public fixed maturity securities are primarily based on market prices from independent pricing services. In addition, 21% of our invested asset portfolio is invested in fixed maturity securities that are private market assets, where there are no readily available market quotes to determine the fair market value. The majority of these assets are valued using a spread pricing matrix that utilizes observable market inputs. Securities are grouped into pricing categories that vary by asset class, sector, rating

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and average life. Each pricing category is assigned a risk spread based on studies of observable public market data or market clearing data from the investment professionals assigned to specific security classes. The expected cash flows of the security are then discounted back at the current Treasury curve plus the appropriate risk spread. Certain market events that could impact the valuation of securities include issuer credit ratings, business climate, management changes, litigation and government actions among others.

Over the past several months, we have seen credit market disruption as the result of widening spreads and illiquid markets. Structured investment transactions where we rely on broker quotes have been particularly impacted given the thinly traded markets (approximately 1% of the fixed maturity securities portfolio). We have received broker quotes that are outside a normal range for historical spreads and, in our view, are generally conservative given the quality of the

underlying cash flows. Analysis has been performed to reconcile these external values to our view of the transaction. In certain circumstances, we have used our internal models in lieu of external values, as we have determined the internal value better reflects fair value.

A rate increase based on the combined movement of interest rates and credit spreads of 100 basis points would produce a total value of approximately \$33.7 billion, as compared to the recorded amount of \$35.1 billion related to our fixed maturity, available-for-sale assets held by the Principal Life general account as of December 31, 2008. Given the recent unprecedented market disruption, a 100 basis point movement in the combined portfolio rate is reasonably likely.

Investments classified as available-for-sale are subject to impairment reviews. When evaluating a fixed maturity security for impairment, we consider relevant facts and circumstances in evaluating whether a credit or interest-related impairment 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) our ability and intent to hold the security for a period of time that allows for the recovery of value which, in some cases, may extend to maturity. When it is determined that the decline in value is other than temporary the carrying value of the security is reduced to its fair value, with a corresponding charge to net income.

There are a number of significant risks and uncertainties inherent in the process of monitoring impairments and determining if an impairment is other than temporary. These risks and uncertainties include: (1) the risk that our assessment of an issuer's ability to meet all of its contractual obligations will change based on changes in the credit characteristics of that issuer; (2) the risk that the economic outlook will be worse than expected or have more of an impact on the issuer than anticipated; (3) the risk that our investment professionals are making decisions based on fraudulent or misstated information in the financial statements provided by issuers and (4) the risk that new information obtained by us or changes in other facts and circumstances lead us to change our intent to hold the security until it recovers in value. Any of these situations could result in a charge to net income in a future period. At December 31, 2008, we had \$31,428.4 million in available-for-sale fixed maturity securities with gross unrealized losses totaling \$8,317.3 million. Included in the gross unrealized losses are losses attributable to both movements in market interest rates as well as movement in credit spreads. Net income would be reduced by approximately \$8,317.3 million, on a pre-tax basis, if all the securities in an unrealized loss position were deemed to be other than temporarily impaired.

**Mortgage Loans.** Mortgage loans consist primarily of commercial mortgage loans on real estate. At December 31, 2008, commercial mortgage loans aggregated to \$11,279.3 million. Commercial mortgage loans are generally reported at cost adjusted for amortization of premiums and accrual of discounts, computed using the interest method and net of valuation allowances. Commercial mortgage loans held for sale are carried at the lower of cost or fair value, less cost to sell, and reported as mortgage loans in the statements of financial position.

Commercial mortgage loans on real estate are considered impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to contractual terms of the loan agreement. When we determine that a loan is impaired, a loss is recognized for the difference between the carrying amount of the mortgage loan and the estimated value. Estimated value is based on either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or fair value of the collateral.

The determination of the calculation and the adequacy of the mortgage loan valuation allowance and mortgage impairments are subjective. Our periodic evaluation and assessment of the adequacy of the mortgage loan valuation allowance and the need for mortgage impairments is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of the underlying collateral, composition of the loan portfolio, current economic conditions, loss experience and other relevant factors. The calculation for determining mortgage impairment amounts includes additional subjectivity, as it requires estimating the amounts and timing of future cash flows expected to be received on specific impaired loans. Thus, our financial position is sensitive to changes in estimated cash flows from mortgages, the value of the collateral and changes in the economic environment in general. The total valuation allowance can be expected to increase when economic conditions worsen and decrease when economic conditions improve.

We have a large experienced commercial real estate staff centrally located in Des Moines, which includes commercial mortgage underwriters, loan closers, loan servicers, engineers, appraisers, credit analysts, research staff, legal staff, information technology personnel and portfolio managers. Experienced commercial real estate senior management adheres to a disciplined process in reviewing all transactions for approval on a consistent basis. The typical commercial mortgage loan for us averages in the upper 50 percent loan-to-value range at origination with a net operating income coverage ratio of 1.7 times the annual debt service and is internally rated A on a bond equivalent basis. Based on the most recent analysis, our commercial mortgage portfolio has an overall loan-to-value ratio of 62% with a 1.8 times debt service coverage. The large equity cushion and strong debt service coverage in our commercial mortgage investments will help insulate us from stress during times of weak commercial real estate fundamentals.



## ***Derivatives***

We primarily use derivatives to hedge or reduce exposure to market risks. The fair values of derivative instruments are determined using either pricing valuation models that utilize market observable inputs or broker quotes. The valuation models consider projected discounted cash flows, relevant swap curves and appropriate implied volatilities. Additionally, we issue certain annuity contracts and other insurance contracts and have certain other obligations that include embedded derivatives that have been bifurcated from the host contract. The fair value of embedded derivatives in annuity contracts and other insurance contracts is calculated based on actuarial and capital market assumptions, including non-performance risk, reflecting the projected cash flows over the life of the contract, and incorporating expected policyholder behavior.

The accounting for derivatives is complex and interpretations of the applicable accounting standards continue to evolve. Judgment is applied in determining the availability and application of hedge accounting designations and the appropriate accounting treatment. Judgment and estimates are used to determine the fair value of some of our derivatives. Volatility in net income can result from changes in fair value of derivatives that do not qualify or are not designated for hedge accounting and changes in fair value of embedded derivatives.

## ***Deferred Policy Acquisition Costs and Other Actuarial Balances***

Commissions and other costs (underwriting, issuance and agency expenses) that vary with and are primarily related to the acquisition of new and renewal insurance policies and investment contract business are capitalized to the extent recoverable. Maintenance costs and acquisition costs that are not deferrable are charged to net income as incurred.

***Amortization Based on Estimated Gross Profits.*** DPAC for universal life-type insurance contracts, participating life insurance policies and certain investment contracts are amortized over the expected lifetime of the policies in relation to estimated gross profits. In addition to DPAC, the following actuarial balances are also amortized in relation to estimated gross profits or contract assessments.

**Sales inducement asset** Sales inducements are amounts that are credited to the contractholder's account balance as an inducement to purchase the contract. Like DPAC, the cost of the sales inducement is capitalized and amortized over the expected life of the contract, in proportion to estimated gross profits.

**Unearned revenue liability** An unearned revenue liability is established when we collect fees or other policyholder assessments that represent compensation for services to be provided in future periods. These revenues are deferred and then amortized over the expected life of the contract, in proportion to estimated gross profits.

**Reinsurance asset or liability** For universal-life type products that are reinsured, a reinsurance asset or liability is established to spread the net reinsurance costs or profits in proportion to the estimated gross profits on the underlying business.

**Present value of future profits ("PVFP")** This is an intangible asset that arises in connection with the acquisition of a life insurance company or a block of insurance business. PVFP is amortized over the expected life of the contracts acquired, in proportion to estimated gross profits.

**Additional benefit reserves** These are additional liabilities that are established for annuity or universal life-type contracts that provide benefit guarantees, or for contracts that are expected to produce profits followed by losses. The liabilities are accrued in relation to estimated contract assessments.

At issue and each valuation date, we develop an estimate of the expected future gross profits. These estimated gross profits contain assumptions relating to mortality, morbidity, lapses, investment yield and expenses. As actual experience emerges, the gross profits may vary from those expected either in magnitude or timing, in which case a true-up to actual occurs as a charge or credit to current net income. In addition, we are required to revise our assumptions regarding future experience as soon as the current assumptions are no longer actuarially credible. Both actions, reflecting actual experience and changing future estimates, can change both the current amount and the future amortization pattern of the DPAC asset and related actuarial balances.

For individual variable life insurance, individual variable annuities and group annuities which have separate account U.S. equity investment options, we utilize a mean reversion methodology (reversion to the mean assumption), a common industry practice, to determine the future domestic equity market growth rate assumption used for the calculation of estimated gross profits. If actual annualized U.S. equity market



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performance varies from our 8% long-term assumption, we assume different performance levels over the next 30 quarters such that the mean return is equal to the long-term assumption over the mean reversion period. However, our mean reversion process generally limits assumed returns to a range of 4-12% during the mean reversion period. The 12% cap was reached during the third quarter of 2008. Therefore, we will not adjust the equity return assumption by the amount needed to result in a mean return equal to the long-term assumption.

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**Internal Replacements.** We review policies for modifications that result in the exchange of an existing contract for a new contract. If the new contract is determined to be an internal replacement that is substantially changed from the replaced contract, any unamortized DPAC and related actuarial balances are written off and acquisition costs related to the new contract are capitalized as appropriate. If the new contract is substantially unchanged, we continue to amortize the existing DPAC and related actuarial balances.

**Recoverability.** DPAC and sales inducement assets are subject to recoverability testing at the time of policy issue and loss recognition testing on an annual basis, or when an event occurs that may warrant loss recognition. Likewise, PVFP is subject to impairment testing on an annual basis, or when an event occurs that may warrant impairment. If loss recognition or impairment is necessary, the asset balances are written off to the extent that it is determined that future policy premiums and investment income or gross profits are not adequate to cover related losses and expenses.

**Sensitivities.** As of December 31, 2008, the net balance of DPAC and related actuarial balances was a \$3,164.2 million asset. We perform sensitivity analyses to assess the impact that certain assumptions have on our DPAC and related actuarial balances. The following table shows the estimated immediate impact of various assumption changes on our DPAC and related actuarial balances.

	Estimated impact to net income (1) (in millions)
Reducing the future equity return assumption by 1%	\$ (8.0)
Reducing the future general account net investment return assumption by 0.5% (2)	\$ (48.8)
Removing the mean reversion methodology from the estimated gross profit calculation	\$ (17.3)
A one-time, 10% drop in equity market values	\$ (11.8)
Increasing all future lapse rate assumptions by 10% of the baseline assumption (3)	\$ (24.7)

- (1) Reflects the net impact of changes to the DPAC asset, sales inducement asset, unearned revenue liability, reinsurance asset or liability, PVFP and additional benefit reserves.
- (2) Net investment return represents net investment income plus net realized capital gains (losses).
- (3) This calculation reflects an increase in lapse rates only for products where increasing the lapse rate leads to a write-down of the DPAC asset. Lapse rates were left unchanged for those products where an increase in lapse rates would lead to a write-up of the DPAC asset.

**Amortization Based on Premium-Paying Period.** DPAC of non-participating term life insurance and individual disability policies are amortized over the premium-paying period of the related policies using assumptions consistent with those used in computing policyholder liabilities. Once these assumptions are made for a given policy or group of policies, they will not be changed over the life of the policy unless a loss recognition event occurs. As of December 31, 2008, these policies accounted for less than 10% of our total DPAC balance.

### Goodwill and Other Intangible Assets

Goodwill and other intangibles include the cost of acquired subsidiaries in excess of the fair value of the net tangible assets recorded in connection with acquisitions. Goodwill and intangible assets with indefinite lives are not amortized. Rather, they are tested for impairment on an annual basis during the fourth quarter each year or more frequently if events or changes in circumstances indicate that the asset might be impaired. The process of evaluating goodwill and other intangibles with indefinite lives for impairment requires several judgments and assumptions to be made to determine the fair value, including the method used to determine fair value, discount rates, expected levels of cash flows, revenues and earnings, and the selection of comparable companies used to develop market-based assumptions.

Intangible assets that do not have indefinite lives are amortized as related benefits emerge and are reviewed periodically for indicators of impairment in value. If facts and circumstances suggest possible impairment, the sum of the estimated undiscounted future cash flows expected to result from the use of the asset is compared to the current carrying value of the asset. If the undiscounted future cash flows are less than the carrying value, an impairment loss is recognized for the excess of the carrying amount of assets over their fair value. For those products amortized as related benefits emerge, the most significant assumptions involved in the estimation of future benefits include surrender/lapse rates, interest margins and mortality.

Despite the challenging economic environment, we did not recognize a material impairment in our 2008 consolidated statement of operations. Investment management contracts acquired in our 2006 purchase of WM Advisors, Inc. is the most material intangible asset included

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in our 2008 consolidated statement of financial position with a carrying value of \$608.0 million. Higher than expected net cash flows and significantly lower than expected expenses more than offset lower than expected market returns on the underlying assets acquired. As a result, the fair value of this intangible asset as of December 31, 2008, was in excess of its carrying value. Although we did not recognize a material impairment in our 2008 consolidated statement of operations, we cannot predict certain future events that might

adversely affect the reported value of goodwill and other intangible assets that totaled \$375.5 million and \$925.3 million as of December 31, 2008, respectively. Such events include, but are not limited to, strategic decisions made in response to economic and competitive conditions, the impact of the economic environment on our customer base, interest rate movements, further declines in the equity markets, the legal environment in which the businesses operate, or a material negative change in our relationships with significant customers. Additional information about impairments is described in Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 4, Goodwill and Other Intangible Assets."

### ***Insurance Reserves***

Reserves are liabilities representing estimates of the amounts that will come due, at some point in the future, to or on behalf of our policyholders. U.S. GAAP, allowing for some degree of managerial judgment, prescribes the methods of establishing reserves.

Future policy benefits and claims include reserves for traditional individual and group life insurance, accident and health insurance and individual and group annuities that provide periodic income payments, which are computed using assumptions of mortality, morbidity, lapse, investment performance and expense. These assumptions are based on our experience and are periodically reviewed against industry standards to ensure actuarial credibility. For long duration insurance contracts, once these assumptions are made for a given policy or group of policies, they will not be changed over the life of the policy. However, significant changes in experience or assumptions may require us to provide for expected future losses on a product by establishing premium deficiency reserves. Premium deficiency reserves may also be established for short duration contracts to provide for expected future losses. Our reserve levels are reviewed throughout the year using internal analysis including, among other things, experience studies, claim development analysis and annual statutory asset adequacy analysis. To the extent experience indicates potential loss recognition, we recognize losses on certain lines of business. The ultimate accuracy of the assumptions on these long-tailed insurance products cannot be determined until the obligation of the entire block of business on which the assumptions were made is extinguished. Short-term variances of actual results from the assumptions used in the computation of the reserves are reflected in current period net income and can impact quarter-to-quarter net income.

Future policy benefits and claims also include reserves for incurred but unreported health, disability and life insurance claims. We recognize claims costs in the period the service was provided to our policyowners. However, claims costs incurred in a particular period are not known with certainty until after we receive, process and pay the claims. We determine the amount of this liability using actuarial methods based on historical claim payment patterns as well as emerging medical cost trends, where applicable, to determine our estimate of claim liabilities. We also look back to assess how our prior periods' estimates developed. To the extent appropriate, changes in such development are recorded as a change to current period claim expense. Historically, the amount of the claim reserve adjustment made in subsequent reporting periods for prior period estimates was within a reasonable range given our normal claim fluctuations.

### ***Benefit Plans***

The reported expense and liability associated with pension and other postretirement benefit plans requires the use of assumptions. Numerous assumptions are made regarding the discount rate, expected long-term rate of return on plan assets, turnover, expected compensation increases, health care claim costs, health care cost trends, retirement rates and mortality. The discount rate and the expected return on plan assets have the most significant impact on the level of cost.

The assumed discount rate is determined by projecting future benefit payments inherent in the Projected Benefit Obligation and discounting those cash flows using a spot yield curve known as the Citigroup Pension Discount Curve. This curve is constructed from the Treasury curve by adding option-adjusted spreads that are drawn from the double-A corporate sector of the Salomon Broad Investment-Grade Bond Index. The bonds with excessive call exposure are excluded, as are securities with option-adjusted spreads that are more than two standard deviations away from the preliminary average. The final spreads are determined using this call-protected sample of double-A corporate bonds. Based on this methodology for 2008 year-end, we set the discount rate at 6.00% as compared to 6.30% for 2007 year-end. A 0.25% decrease in the discount rate would increase pension benefits Projected Benefit Obligation and the 2009 Net Periodic Pension Cost ("NPPC") by approximately \$65.4 million and \$9.7 million, respectively. A 0.25% decrease in the discount rate would increase other postretirement benefits Accumulated Postretirement Benefit Obligation and the 2009 Net Periodic Benefit Cost ("NPBC") by approximately \$11.8 million and \$1.3 million, respectively. A 0.25% increase in the discount rate would result in decreases in benefit obligations and expenses at a level generally commensurate with those noted above.

The assumed long-term rate of return on plan assets is set at the long-term rate expected to be earned based on the long-term investment policy of the plans and the various classes of the invested funds. Historical and future expected returns of multiple asset classes were analyzed to develop a risk-free real rate of return and risk premiums for each asset class. The overall long-term rate for each asset class was developed by combining a long-term inflation component, the risk free real rate of return and the associated risk premium. A weighted average rate was developed based on long-term returns for each asset class, the plan's target asset allocation policy and the tax structure of the trusts. For the 2008 NPPC



and 2008 NPBC, an 8.25% and 7.30% weighted average long-term rate of return was used, respectively. For the 2009 NPBC and 2009 NPBC, an 8.00% and 7.30% weighted average long-term rate of return assumption will be used, respectively. A 0.25% decrease in the assumed long-term rate of return would increase 2009 NPBC by approximately \$2.5 million and the 2009 NPBC by approximately \$0.9 million. A 0.25% increase in this rate would result in a decrease to expense at the same levels. The assumed return on plan assets is based on the fair market value of plan assets as of December 31, 2008.

The compensation increase assumption is generally set at a rate consistent with current and expected long-term compensation and salary policy, including inflation.

Actuarial gains and losses are amortized using a straight-line amortization method over the average remaining service period of employees, which is approximately 8 years for pension costs and approximately 13 years for other postretirement benefit costs.

Prior service costs are amortized on a weighted average basis over approximately 6 years for both pension and other postretirement benefit costs.

### ***Income Taxes***

We provide for income taxes based on our estimate of the liability for taxes due. Our tax accounting represents management's best estimate of various events and transactions, such as completion of tax audits or establishment of, or changes to, a valuation allowance associated with certain deferred tax assets, which could affect our estimates and effective tax rate in a particular quarter or annual period.

Inherent in the provision for income taxes are estimates regarding the deductibility of certain items, the timing of income and expense recognition and the current or future realization of capital losses and certain tax credits. The current economic environment has resulted in a significant increase in realized and unrealized losses on our fixed maturity securities. The corresponding deferred tax asset by taxing jurisdiction will more likely than not be fully realized considering our buy-and-hold investment philosophy for securities experiencing unrealized losses and available tax planning strategies that management is willing to implement for securities experiencing realized losses, if necessary. Our tax planning strategy is to sell various appreciated securities and other capital assets that if sold would result in sufficient capital gains to realize the deferred tax assets, thus minimizing the need for a valuation allowance.

In the event our estimates of the ultimate deductibility of certain items, the timing of the recognition of income and expense or the current or future realization of capital losses and certain tax credits differ from prior estimates due to the receipt of new information, we may be required to significantly change the provision for income taxes recorded in the consolidated financial statements. Any such change could significantly affect the amounts reported in the consolidated financial statements in the year these estimates change. A further significant decline in value of assets incorporated into our tax planning strategies could lead to an increase of our valuation allowance on deferred tax assets having an adverse effect on current and future results.

In addition, the amount of income taxes paid is subject to audits in various jurisdictions. Tax benefits are recognized for book purposes when the more-likely-than-not threshold is met with regard to the validity of an uncertain tax position. Once this threshold is met, for each uncertain tax position, we recognize in earnings the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement with the IRS or other income taxing authorities for audits ongoing or not yet commenced. We had \$226.2 million and \$251.5 million of current income tax receivables associated with outstanding audits reported as other assets in our consolidated statements of financial position as of December 31, 2008 and 2007, respectively. We believe that we have adequate defenses against, or sufficient provisions for, the contested issues, but final resolution of contested issues could take several years while legal remedies are pursued. Consequently, we do not anticipate the ultimate resolution of audits ongoing or not yet commenced to have a material impact on our net income.

### **Transactions Affecting Comparability of Results of Operations**

#### ***Acquisitions***

We acquired the following businesses, among others, during the past three years:

***Morley Financial Services, Inc.*** On August 31, 2007, we acquired Morley Financial Services, Inc. ("Morley Financial Services") from Nationwide Mutual Insurance Company, for \$75.0 million in cash. Morley Financial Services is a stable value asset manager with approximately \$14.0 billion in institutional AUM at the time of purchase. The operations of Morley Financial Services are reported and consolidated in our Global Asset Management segment.

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**WM Advisors, Inc.** On December 31, 2006, we acquired WM Advisors, Inc. and its subsidiaries from Washington Mutual, Inc. for a total cost of \$741.1 million in cash at the time of closing. As of December 31, 2006, WM Advisors, Inc. had approximately \$28.0 billion in AUM and provided investment advisory services to mutual funds, variable trust funds

and asset allocation portfolios to approximately 800,000 shareholder accounts nationwide. The operations of WM Advisors, Inc. are reported and consolidated in our U.S. Asset Accumulation and Global Asset Management segments.

**Principal Global Services Private Limited.** In December 2005, we formed Principal Global Services Private Limited ("PGS"), which began operations in Pune, India, as of August 2006. PGS employees perform services for our U.S. operations including claims data entry, 401(k) processing, information technology ("IT") coding/application development and IT quality assurance. PGS start-up costs were reported in our Corporate segment through 2006. Beginning in 2007, expenses are allocated to the segments for which services are performed.

#### **Dispositions**

We entered into disposition agreements or disposed of the following businesses, among others, during the past three years:

**Post Advisory Group, LLC.** Effective January 1, 2009, we sold certain asset management contracts within our Post Advisory Group, LLC subsidiary. The transaction does not qualify for discontinued operations treatment under U.S. GAAP. The realized capital gain from the sale, which will be reflected in our Global Asset Management segment, is not material.

**Principal Dental Services, Inc.** Effective July 1, 2006, we sold five dental offices which were substantially all of the assets of Dental Net Group, one component of Principal Dental Services, Inc. The realized gain was reported in our Life and Health segment.

**Discontinued Operations.** For divestitures that qualify for discontinued operations treatment, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 3, Discontinued Operations."

#### **Other**

**Commercial Mortgage Securities Issuance Operation.** During the third quarter of 2008, we made a decision to terminate our commercial mortgage securities issuance operation which does not qualify for discontinued operations treatment under U.S. GAAP. Therefore, the results of the terminated commercial mortgage securities issuance operation are still included in our consolidated income from continuing operations.

As a result of our decision to terminate our commercial mortgage securities issuance operation, amounts previously included in our Global Asset Management segment operating earnings related to this operation have been removed from operating earnings for all periods presented and are reported as other after-tax adjustments. Our commercial mortgage securities issuance operation had operating revenues of \$(32.2) million, \$30.1 million and \$60.6 million for the years ended December 31, 2008, 2007 and 2006, respectively and after-tax operating earnings (losses) of \$(28.1) million, \$5.7 million and \$28.7 million for the years ended December 31, 2008, 2007 and 2006, respectively.

**SBB Mutual Berhad and SBB Asset Management Sdn Bhd.** On February 5, 2007, we invested an additional RM\$192.4 million Malaysian ringgits ("RM\$") (approximately U.S. \$55.1 million) to retain our 40% ownership interest in CIMB-Principal, our joint venture company in Malaysia, as a result of its decision to purchase the mutual fund and asset management companies of the former Southern Bank Bhd ("SBB") Mutual Berhad and SBB Asset Management Sdn Bhd.

**Senior Note Issuance.** During fourth quarter 2006, we issued \$600.0 million of senior notes. The notes bear interest at a rate of 6.05% per year. Interest on the notes is payable semi-annually on April 15 and October 15, and began on April 15, 2007. The notes will mature on October 15, 2036. A portion of the proceeds was used to fund the acquisition of WM Advisors, Inc., with the remaining proceeds being used for general corporate purposes.

**Reinsurance Subsidiaries.** In December 2008, Principal Life established a wholly owned insurance subsidiary, Principal Life Insurance Company of Iowa II, which reinsured a portion of our universal life "secondary" or "no-lapse" guarantee provisions, through an intercompany reinsurance agreement with Principal Life. The reinsurance agreement, which is guaranteed by PFG, allows us to redeploy capital for other corporate purposes.

In November 2006, Principal Life established a wholly owned reinsurance subsidiary, Principal Reinsurance Company of Vermont ("PVT"), which reinsured a portion of our universal life "secondary" or "no-lapse" guarantee provisions as well as our current term product, through intercompany reinsurance agreements with Principal Life. The reinsurance agreements, which are accompanied with a third party letter of credit issued to PVT and guaranteed by PFG, allow us to redeploy capital for other general corporate purposes.

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



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

into U.S. dollars results in fewer U.S. dollars to be reported. When foreign currencies strengthen, translating foreign currencies into U.S. dollars results in more U.S. dollars to be reported.

Foreign currency exchange rate fluctuations create variances in our financial statement line items but have not had a material impact on our consolidated income from continuing operations. Our consolidated income from continuing operations was positively impacted \$6.1 million, \$5.9 million and \$5.4 million for the years ended December 31, 2008, 2007 and 2006, respectively, as a result of fluctuations in foreign currency to U.S. dollar exchange rates for our foreign operations. For a discussion of our approaches to foreign currency exchange rate risk, see Item 7A. "Quantitative and Qualitative Disclosures about Market Risk Foreign Currency Risk."

## Stock-Based Compensation Plans

For information related to our Stock-Based Compensation Plans, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 20, Stock-Based Compensation Plans."

## Defined Benefit Pension and 401(k) Expense

The 2008 annual pension benefit expense that was reflected in net income for substantially all of our employees and certain agents was \$12.3 million pre-tax, which was an \$11.8 million decrease from the 2007 pre-tax pension expense of \$24.1 million. This decrease is primarily due to the increase in discount rate and greater than estimated returns on plan assets. The expected long-term return on plan assets assumption remained at 8.25%. The discount rate used to develop the 2008 expense was raised to 6.3%, up from the 6.15% discount rate used to develop the 2007 expense.

The 2009 annual pension benefit expense for substantially all of our employees and certain agents is expected to be \$157.6 million pre-tax, which is a \$145.3 million increase from the 2008 pre-tax pension expense that was reflected in net income of \$12.3 million. This increase is primarily due to much lower than expected asset returns and a decrease in our discount rate. The expected long-term return on plan asset assumption was lowered to 8.0% based on a review of this assumption during 2008. The discount rate used to develop the 2009 expense was lowered to 6.0%, down from the 6.3% discount rate used to develop the 2008 expense.

## Recent Accounting Changes

For recent accounting changes, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 1, Nature of Operations and Significant Accounting Policies."

## Results of Operations

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

	For the year ended December 31,			Increase (decrease)	
	2008	2007	2006	2008 vs. 2007	2007 vs. 2006
	(in millions)				
<b>Revenues:</b>					
Premiums and other considerations	\$ 4,209.2	\$ 4,634.1	\$ 4,305.3	\$ (424.9)	\$ 328.8
Fees and other revenues	2,426.5	2,634.7	1,902.5	(208.2)	732.2
Net investment income	3,994.3	3,966.5	3,620.6	27.8	345.9
Net realized capital gains (losses)	(694.1)	(328.8)	44.7	(365.3)	(373.5)
<b>Total revenues</b>	<b>9,935.9</b>	<b>10,906.5</b>	<b>9,873.1</b>	<b>(970.6)</b>	<b>1,033.4</b>
<b>Expenses:</b>					
Benefits, claims and settlement expenses	6,219.9	6,435.3	5,692.4	(215.4)	742.9
Dividends to policyholders	267.3	293.8	290.7	(26.5)	3.1
Operating expenses	2,995.1	3,129.2	2,558.7	(134.1)	570.5
<b>Total expenses</b>	<b>9,482.3</b>	<b>9,858.3</b>	<b>8,541.8</b>	<b>(376.0)</b>	<b>1,316.5</b>
<b>Income from continuing operations before income taxes</b>	<b>453.6</b>	<b>1,048.2</b>	<b>1,331.3</b>	<b>(594.6)</b>	<b>(283.1)</b>

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Income taxes (benefits)	(4.5)	208.1	295.9	(212.6)	(87.8)
Income from continuing operations, net of related income taxes	458.1	840.1	1,035.4	(382.0)	(195.3)
Income from discontinued operations, net of related income taxes		20.2	28.9	(20.2)	(8.7)
Net income	458.1	860.3	1,064.3	(402.2)	(204.0)
Preferred stock dividends	33.0	33.0	33.0		
Net income available to common stockholders	\$ 425.1	\$ 827.3	\$ 1,031.3	\$ (402.2)	\$ (204.0)

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*Year Ended December 31, 2008 Compared to Year Ended December 31, 2007*

### **Net Income Available to Common Stockholders**

Net income available to common stockholders decreased primarily due to a \$248.4 million after-tax increase in net realized capital losses. The change in net realized capital losses was primarily driven by higher impairments, net of recoveries from sales, on fixed maturity and equity securities and mark to market losses versus gains on fixed maturity and equity securities classified as trading. In addition, net income available to common stockholders for the U.S. Asset Accumulation segment decreased primarily due to a decline in account values in our full service accumulation business stemming from poor equity markets in 2008 and shifts in the mix of business.

### **Total Revenues**

Premiums decreased \$195.5 million for the Life and Health Insurance segment primarily due to a reduction in average covered medical members in our health insurance business. In addition, U.S. Asset Accumulation segment premiums decreased \$187.6 million primarily due to a decrease in sales of single premium group annuities with life contingencies within our full service payout business, which was partially offset by an increase in our individual payout annuities business primarily relating to increased sales of annuities with life contingencies.

Fees decreased \$244.9 million for our U.S. Asset Accumulation segment due to a decline in account values stemming from poor equity markets in 2008 and shifts in the mix of business.

Net investment income increased due to a slight increase in the average annualized yield on invested assets and cash, which was 6.3% and 6.2% for the years ended December 31, 2008 and 2007, respectively.

Net realized capital gains (losses) can be volatile due to mark to market adjustments of certain invested assets, other than temporary impairments of invested assets, and our decision to sell appreciated invested assets. Net realized capital losses increased primarily due to higher impairments, net of recoveries from sales, on fixed maturity and equity securities and mark to market losses versus gains on fixed maturity and equity securities classified as trading. For additional information, see "Investments Investment Results."

### **Total Expenses**

Benefits, claims and settlement expenses decreased \$189.6 million for the Life and Health Insurance segment, primarily due to a decrease in average covered medical members in our health insurance business.

Operating expenses decreased \$83.1 million for the Corporate segment, primarily due to a decline in amounts credited to employee accounts in a nonqualified defined contribution pension plan, which was offset by a corresponding reduction in net realized capital gains related to the assets backing this nonqualified plan. In addition, U.S. Asset Accumulation operating expenses decreased \$69.6 million, primarily due to a comprehensive assumption study in our full service accumulation business that was completed during the third quarter of 2007, which resulted in the unlocking of our unearned revenue and DPAC assumptions and led to the recognition of previously deferred expenses in 2007.

### **Income Taxes**

The effective income tax rates were -1% and 20% for the years ended December 31, 2008 and 2007, respectively. The effective income tax rate for the year ended December 31, 2008, was lower than the U.S. corporate income tax rate of 35% ("U.S. statutory rate") primarily due to income tax deductions allowed for corporate dividends received, interest exclusion from taxable income and additional U.S. foreign tax credits resulting from the second quarter 2008 enactment of legislation to increase the Brazilian tax rate. The effective income tax rate for the year ended December 31, 2007, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received and interest exclusion from taxable income. The effective income tax rate decreased to -1% from 20% for the years ended December 31, 2008 and 2007, respectively, primarily due to an increase in our net realized capital losses with no proportionate change in permanent items, additional U.S. foreign tax credits resulting from the aforementioned Brazilian tax rate increase and tax refinements made in 2007 related to prior years. The net increase in deferred tax liabilities associated with the newly enacted Brazilian income tax rate is reflected in net investment income because the equity method of accounting is applied to our Brazilian operations; however, the benefit from additional U.S. foreign tax credits is reflected in income tax expense.

*Year Ended December 31, 2007 Compared to Year Ended December 31, 2006*

### **Net Income Available to Common Stockholders**

Net income available to common stockholders decreased primarily due to a \$240.0 million after-tax change in net realized capital losses. The change in net realized capital losses was primarily driven by higher other than temporary impairments, net of recoveries, of fixed maturity

securities and as well as higher mark to market losses on derivative activities.

### **Total Revenues**

Premiums increased \$248.5 million for the U.S. Asset Accumulation segment primarily due to an increase in sales of single premium group annuities with life contingencies within our full service payout business and an increase in our individual payout annuities business primarily relating to increased sales from certain distribution channels. In addition, Life and Health Insurance segment premiums increased \$72.9 million primarily due to growth in our specialty benefits business.

Fees increased \$590.7 million for our U.S. Asset Accumulation segment due to higher management and distribution fees for Principal Funds stemming from an increase in average account values resulting from our December 31, 2006, acquisition of WM Advisors, Inc. In addition, fees from our full service accumulation business increased due to a comprehensive assumption study that was completed during the third quarter 2007 which resulted in the unlocking of our unearned revenue and DPAC assumptions and led to the recognition of previously deferred revenue.

Net investment income increased due to a \$3,376.8 million increase in average invested assets and cash and an increase in the annualized investment yield. The yield on average invested assets and cash was 6.2% for the year ended December 31, 2007, compared to 6.0% for the year ended December 31, 2006.

Net realized capital gains (losses) can be volatile due to mark to market adjustments of certain invested assets, our decision to sell appreciated invested assets and other than temporary impairments of invested assets. Net realized capital losses increased primarily due to higher impairments, net of recoveries, on fixed maturity securities as well as higher mark to market losses on derivative activities. For additional information, see "Investments Investment Results."

### **Total Expenses**

Benefits, claims and settlement expenses increased \$416.4 million for the U.S. Asset Accumulation segment, primarily due to an increase in reserves related to higher sales of individual payout annuities and higher cost of interest credited related to a growing block in our individual annuities business. In addition, in full service payout, benefit reserves and expense increased primarily due to strong sales of single premium group annuities with life contingencies. Benefits, claims and settlement expenses also increased \$201.1 million for the Life and Health Insurance segment, primarily due to growth in our specialty benefits business and due to higher medical costs and unfavorable prior year claim development in our health insurance business.

U.S. Asset Accumulation operating expenses increased \$461.4 million, primarily due to an increase within Principal Funds relating to higher costs associated with an increase in staff and infrastructure needed to support the growth in the business and the impact from the WM Advisors, Inc. acquisition. In addition, a \$108.6 million increase from the Global Asset Management segment, primarily in our fee mandate business, was due to continued growth in staff and staff-related costs as a result of continued growth in AUM and the acquisitions of Edge Asset Management and Morley Financial Services.

### **Income Taxes**

The effective income tax rates were 20% and 22% for the years ended December 31, 2007 and 2006, respectively. The effective income tax rate for the year ended December 31, 2007, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received and interest exclusion from taxable income. The effective income tax rate for the year ended December 31, 2006, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received, interest exclusion from taxable income and tax refinements in Mexico and Chile.

### **Results of Operations by Segment**

For results of operations by segment see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 19, Segment Information."

#### **U.S. Asset Accumulation Segment**

##### ***U.S. Asset Accumulation Trends***

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



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The following table presents the U.S. Asset Accumulation account value rollforward for the years indicated:

	For the year ended December 31,		
	2008	2007	2006
	(in billions)		
Account values, beginning of period	\$ 180.8	\$ 163.3	\$ 120.3
Net cash flow	5.0	6.7	6.9
Credited investment performance	(37.6)	10.3	13.0
Other	(2.1)	0.5	23.1(1)
Account values, end of period	\$ 146.1	\$ 180.8	\$ 163.3

(1)

Includes \$22.5 billion relating to the December 31, 2006, acquisition of WM Advisors, Inc.

### U.S. Asset Accumulation Segment Summary Financial Data

The following table presents certain summary financial data relating to the U.S. Asset Accumulation segment for the years indicated:

	For the year ended December 31,			Increase (decrease)	
	2008	2007	2006	2008 vs. 2007	2007 vs. 2006
	(in millions)				
Operating revenues:					
Premiums and other considerations	\$ 523.2	\$ 710.8	\$ 462.3	\$ (187.6)	\$ 248.5
Fees and other revenues	1,455.1	1,691.4	1,105.9	(236.3)	585.5
Net investment income	2,820.1	2,748.0	2,538.8	72.1	209.2
Total operating revenues	4,798.4	5,150.2	4,107.0	(351.8)	1,043.2
Expenses:					
Benefits, claims and settlement expenses, including dividends to policyholders	2,711.5	2,812.6	2,392.1	(101.1)	420.5
Operating expenses	1,417.4	1,510.1	1,040.8	(92.7)	469.3
Total expenses	4,128.9	4,322.7	3,432.9	(193.8)	889.8
Operating earnings before income taxes	669.5	827.5	674.1	(158.0)	153.4
Income taxes	138.2	171.7	131.5	(33.5)	40.2
Operating earnings	\$ 531.3	\$ 655.8	\$ 542.6	\$ (124.5)	\$ 113.2

### Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

#### Operating Earnings

Operating earnings in our full service accumulation business decreased \$95.1 million primarily due to a decrease in account values stemming from poor equity markets in 2008 and the shifts in mix of business. Furthermore, 2007 results benefited from the third quarter 2007 completion of a comprehensive assumption study, which resulted in the unlocking of our unearned revenue and DPAC assumptions and led to the recognition of a \$30.1 million after-tax operating earnings benefit. To a lesser extent, operating earnings were reduced by a decline in the tax benefits associated with the dividend received deduction stemming from a declining equity environment. In addition, operating earnings in our Principal Funds business decreased \$18.7 million primarily due to lower management fees stemming from a decrease in average account values due to the poor equity markets in 2008.

#### Operating Revenues



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Premiums in our full service payout business decreased \$253.3 million primarily due to a decrease in sales of single premium group annuities with life contingencies. The single premium group annuity product, which is typically used to fund defined benefit plan terminations, can generate large premiums from very few customers and therefore tends to vary from period to period. Partially offsetting this decrease was a \$65.7 million increase in premiums from our individual payout annuities business due to increased sales of annuities with life contingencies.

Fees in our full service accumulation business decreased \$190.7 million primarily due to the third quarter 2007 completion of a comprehensive assumption study, which resulted in the unlocking of our unearned revenue assumptions and led to the recognition of previously deferred revenue in 2007. Furthermore, fees decreased due to a decline in account values stemming from poor equity markets in 2008 and shifts in the mix of business. Fees in our Principal Funds

business decreased \$65.2 million primarily due to lower management and distribution fees stemming from a decrease in average account values due to poor equity markets in 2008.

Net investment income increased primarily due to an \$802.6 million increase in average invested assets and cash. Average annualized yield on invested assets and cash was 5.8% for both the years ended December 31, 2008 and 2007.

### **Total Expenses**

Benefits, claims and settlement expenses decreased \$252.8 million within our full service payout business primarily due to a decrease in single premium group annuity sales. In addition, our investment only business decreased \$55.0 million primarily due to a decrease in cost of interest credited on this block of business resulting from a decrease in account values and lower crediting rates. Partially offsetting the decrease was a \$190.4 million increase within our individual annuities business primarily due to an increase in cost of interest credited on fixed deferred annuities related to normal growth in the block and, to a lesser extent, an increase in reserves related to higher sales of individual payout annuities with life contingencies.

Operating expenses in our full service accumulation business decreased \$101.0 million primarily due to the third quarter 2007 completion of a comprehensive assumption study, which resulted in the unlocking of our DPAC assumptions and led to the recognition of previously deferred expenses in 2007. Also contributing to lower operating expenses were decreases in normal DPAC amortization due to lower current period earnings and lower asset management expense stemming from a decrease in account values. Operating expenses decreased \$34.8 million within Principal Funds primarily due to lower asset based expenses stemming from a decrease in average account values, which resulted from poor equity markets in 2008. Partially offsetting the overall decrease was a \$48.8 million increase in our individual annuities business primarily due to increased DPAC amortization expense on variable annuities as a result of the negative equity market performance experienced throughout 2008 and, to a lesser extent, increased expenses related to the normal growth in the block of fixed annuities.

### **Income Taxes**

The effective income tax rate for the segment was 21% for both the years ended December 31, 2008 and 2007. The effective income tax rates were lower than the U.S. statutory rate, primarily due to income tax deductions allowed for corporate dividends received and interest exclusion from taxable income.

### ***Year Ended December 31, 2007 Compared to Year Ended December 31, 2006***

### **Operating Earnings**

Full service accumulation operating earnings increased \$68.1 million primarily due to an increase in account values stemming from solid investment performance and strong net cash flows. In addition, the 2007 results benefited from the third quarter 2007 completion of a comprehensive assumption study, which resulted in the unlocking of our unearned revenue and DPAC assumptions and led to the recognition of an operating earnings benefit of \$30.1 million after-tax. Principal Funds operating earnings increased \$23.4 million primarily due to higher net commission income and management fees stemming from an increase in sales and an increase in average account values.

### **Operating Revenues**

Premiums in our full service payout business increased \$140.0 million primarily due to an increase in sales of single premium group annuities with life contingencies. The single premium group annuity product, which is typically used to fund defined benefit plan terminations, can generate large premiums from very few customers and therefore tends to vary from period to period. Premiums in our individual payout annuities business increased \$108.5 million primarily due to increased sales from certain distribution channels.

Fees in our Principal Funds business increased \$346.0 million primarily due to higher management and distribution fees stemming from an increase in average account values resulting from our December 31, 2006, acquisition of WM Advisors, Inc. Fees in our full service accumulation business increased \$208.6 million primarily due to a comprehensive assumption study that was completed during the third quarter 2007, which resulted in the unlocking of our unearned revenue and DPAC assumptions and led to the recognition of previously deferred revenue. Higher fees generated from the increase in account values also contributed to the increase.

Net investment income increased primarily due to a \$3,097.4 million increase in average invested assets and cash. Average annualized yield on invested assets and cash was 5.8% for both the years ended December 31, 2007 and 2006.

### **Total Expenses**

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Benefits, claims and settlement expenses increased \$195.9 million within our individual annuities business primarily due to an increase in reserves related to higher sales of individual payout annuities. Also, as a result of a growing block of

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individual annuities, cost of interest credited on fixed deferred annuities increased. In addition, in full service payout, benefit reserves and expenses increased \$141.9 million, primarily due to strong sales of single premium group annuities with life contingencies. Furthermore, our investment only business increased \$81.9 million primarily due to an increase in cost of interest credited on this block of business resulting from an increase in account values and higher crediting rates.

Operating expenses increased \$305.5 million within Principal Funds primarily due to higher costs associated with an increase in staff and infrastructure needed to support the growth in the business and the impact from the WM Advisors, Inc. acquisition. Operating expenses in our full service accumulation business increased \$120.9 million primarily due to a comprehensive assumption study that was completed during the third quarter 2007, which resulted in the unlocking of our unearned revenue and DPAC assumptions and led to the recognition of previously deferred expenses. Also contributing to the increase was growth in the business, which drove increases in staff related costs and management fees paid.

### Income Taxes

The effective income tax rates for the segment were 21% and 20% for the years ended December 31, 2007 and 2006, respectively. The effective income tax rates were lower than the U.S. statutory rate, primarily due to income tax deductions allowed for corporate dividends received and interest exclusion from taxable income.

### Global Asset Management Segment

#### Global Asset Management Trends

While we have experienced success in winning institutional asset management mandates and expect to see continued growth in this area, the market conditions have impacted our overall AUM growth across all asset classes. Our third-party AUM decreased \$17.0 billion during 2008 primarily as a result of market performance.

The following table provides a summary of Global Asset Management's affiliated and third-party AUM as of December 31, 2008, 2007 and 2006:

As of	Principal Global Investors		
	Affiliated AUM	Third-party AUM	Total AUM
	<i>(in billions)</i>		
December 31, 2008	\$ 119.7	\$ 70.3	\$ 190.0
December 31, 2007	148.7	87.3	236.0
December 31, 2006	132.3	59.1	191.4

#### Global Asset Management Segment Summary Financial Data

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

The following table presents AUM rollforward for assets managed by Global Asset Management for the years indicated:

	For the year ended December 31,		
	2008	2007	2006
	<i>(in billions)</i>		
AUM, beginning of period	\$ 236.0	\$ 191.4	\$ 144.5
Net cash flow	3.3	15.8	12.8
Investment performance	(46.0)	12.5	13.7
Operations acquired (1)		13.7	22.6
Other	(3.3)	2.6	(2.2)
AUM, end of period	\$ 190.0	\$ 236.0	\$ 191.4

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(1)

Includes acquisition of Morley Financial Services in 2007 and acquisition of WM Advisors, Inc. in 2006.

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The following table presents certain summary financial data relating to the Global Asset Management segment for the years indicated:

	For the year ended December 31,			Increase (decrease)	
	2008	2007	2006	2008 vs. 2007	2007 vs. 2006
	(in millions)				
Operating revenues:					
Fees and other revenues	\$ 577.3	\$ 536.8	\$ 392.7	\$ 40.5	\$ 144.1
Net investment income	21.2	36.1	34.8	(14.9)	1.3
Total operating revenues	598.5	572.9	427.5	25.6	145.4
Expenses:					
Total expenses	453.2	414.4	314.7	38.8	99.7
Operating earnings before income taxes	145.3	158.5	112.8	(13.2)	45.7
Income taxes	50.9	55.7	39.0	(4.8)	16.7
Operating earnings	\$ 94.4	\$ 102.8	\$ 73.8	\$ (8.4)	\$ 29.0

### *Year Ended December 31, 2008 Compared to Year Ended December 31, 2007*

#### **Operating Earnings**

Operating earnings in our spread business decreased \$5.6 million primarily due to lower earnings as a result of lower investment income and loan volumes in 2008 compared to 2007. Operating earnings in our fee mandate business decreased \$2.8 million as a decline in borrower fees and transaction fees from our real estate line of business was partially offset by an increase in management and performance fee revenues.

#### **Operating Revenues**

Fees in our fee mandate business increased \$44.1 million due to higher management fees and performance fees despite the adverse market conditions, which have dampened our overall growth. In addition to the acquisition of Morley Financial Services, we continued to see growth in management fees from our fixed income and equity lines of business, however, borrower fees and transaction fees have decreased due to lower real estate activity. Partially offsetting the fee mandate business increase is a decrease in our spread business of \$3.6 million due to lower loan origination fees in 2008 compared to 2007.

Net investment income decreased \$7.7 million in our spread business due to lower investment income earned on our loan portfolio. Net investment income decreased \$7.2 million in our fee mandate business as a result of the declining interest rate environment.

#### **Total Expenses**

Total expenses increased \$41.3 million in our fee mandate business due to growth in staff related costs, primarily as a result of incentive compensation paid on performance fees received during the fourth quarter of 2008, as well as the acquisition of Morley Financial Services in the third quarter of 2007.

#### **Income Taxes**

The effective income tax rate for the segment was 35% for both the years ended December 31, 2008 and 2007.

### *Year Ended December 31, 2007 Compared to Year Ended December 31, 2006*

#### **Operating Earnings**

Operating earnings increased \$28.9 million in our fee mandate business primarily due to strong net cash flows that drove an increase in AUM.

#### **Operating Revenues**

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Fees increased \$142.6 million in our fee mandate business due to continued growth in management fees across all lines of business, as a result of growth in AUM, in addition to the acquisition of Edge Asset Management and Morley Financial Services.

Net investment income increased \$1.5 million in our fee mandate business due to earnings on cash and other investments.

## Total Expenses

Total expenses increased \$99.2 million in our fee mandate business due to growth in staff and staff related costs as a result of continued growth in AUM and the acquisitions of Edge Asset Management and Morley Financial Services.

## Income Taxes

The effective income tax rate for the segment was 35% for both the years ended December 31, 2007 and 2006.

## International Asset Management and Accumulation Segment

### *International Asset Management and Accumulation Trends*

Our international asset management and accumulation businesses focus on countries with favorable demographics and growing long-term savings and defined contribution markets. With variations depending upon the specific country, we have targeted these markets for sales of retirement and related products and services, including defined contribution pension plans, annuities and mutual funds to businesses and individuals. In some of our international markets, we complement our sales of these products with institutional asset management and life insurance accumulation products.

We have pursued our international strategy through a combination of start-ups, acquisitions and joint ventures, which require infusions of capital consistent with our strategy of long-term growth and profitability.

### *International Asset Management and Accumulation Segment Summary Financial Data*

AUM is a key indicator of earnings growth for the segment, as AUM is the base by which we can generate profits. Net cash flow and market performance are the two main drivers of AUM growth. Net cash flow reflects our ability to attract and retain client deposits. Market performance reflects the investment returns on our underlying AUM. The percentage growth in the earnings of our International Asset Management and Accumulation segment will generally track with the percentage growth in AUM. This trend may vary due to changes in business and/or product mix. Our financial results are also impacted by fluctuations of the foreign currency to U.S. dollar exchange rates for the countries in which we have business.

The following table presents the International Asset Management and Accumulation AUM rollforward for the years indicated:

	For the year ended December 31,		
	2008	2007	2006
	(in billions)		
AUM, beginning of period	\$ 28.7	\$ 19.1	\$ 15.4
Net cash flow	1.0	2.1	2.0
Investment performance	(1.6)	3.0	2.0
Effect of exchange rates	(5.0)	2.3	0.1
Other (1)		2.2	(0.4)
AUM, end of period	\$ 23.1	\$ 28.7	\$ 19.1

(1)

Other increases to AUM include \$2.2 billion from our SBB acquisition in Malaysia in 2007.



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The following table presents certain summary financial data of the International Asset Management and Accumulation segment for the years indicated:

	For the year ended December 31,			Increase (decrease)	
	2008	2007	2006	2008 vs. 2007	2007 vs. 2006
	<i>(in millions)</i>				
Operating revenues:					
Premiums and other considerations	\$ 204.1	\$ 246.4	\$ 239.1	\$ (42.3)	\$ 7.3
Fees and other revenues	123.1	136.4	114.0	(13.3)	22.4
Net investment income	521.8	413.5	252.3	108.3	161.2
<b>Total operating revenues</b>	<b>849.0</b>	<b>796.3</b>	<b>605.4</b>	<b>52.7</b>	<b>190.9</b>
Expenses:					
Benefits, claims and settlement expenses	586.6	526.7	399.1	59.9	127.6
Operating expenses	150.6	141.4	144.5	9.2	(3.1)
<b>Total expenses</b>	<b>737.2</b>	<b>668.1</b>	<b>543.6</b>	<b>69.1</b>	<b>124.5</b>
Operating earnings before income taxes	111.8	128.2	61.8	(16.4)	66.4
Income taxes (benefits)	(14.5)	17.5	(10.0)	(32.0)	27.5
<b>Operating earnings</b>	<b>\$ 126.3</b>	<b>\$ 110.7</b>	<b>\$ 71.8</b>	<b>\$ 15.6</b>	<b>\$ 38.9</b>

### *Year Ended December 31, 2008 Compared to Year Ended December 31, 2007*

#### **Operating Earnings**

Operating earnings in our equity method investment in Brazil increased \$11.1 million primarily due to the strengthening of the Brazilian real versus the U.S. dollar, coupled with pricing changes resulting in higher fees and net unlocking and true-up adjustments that lowered DPAC and PVFP amortization. Operating earnings in Chile increased \$6.1 million primarily due to higher inflation-based investment returns net of interest crediting to customers.

#### **Operating Revenues**

Premiums in Chile decreased \$40.6 million primarily due to lower sales of single premium annuities with life contingencies.

Fees and other revenues decreased \$10.0 million primarily due to lower AUM and reduced fee charges for our operations in India. In addition, fees and other revenues decreased \$4.0 million in Chile due to 2008 unlocking adjustments, which lowered unearned revenue accruals, and lower AUM.

Net investment income increased primarily due to a higher annualized yield on average invested assets and cash, excluding our equity method investments, due to larger inflation-based investment returns in Chile. The annualized yield on average invested assets and cash, excluding our equity method investments, was 13.8% and 10.3% for the years ended December 31, 2008 and 2007, respectively.

#### **Total Expenses**

Benefits, claims and settlement expenses increased \$54.4 million in Chile, primarily due to higher interest crediting rates in 2008, which was partially offset by a lower change in reserve expense associated with decreased sales of single premium annuities with life contingencies.

Operating expenses in Mexico increased \$13.8 million primarily due to net unlocking and true-up adjustments resulting in lower DPAC and PVFP amortization in 2007 related to enacted legislation. This increase in operating expenses was partially offset by lower compensation costs for our corporate headquarters.

#### **Income Taxes**

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The effective income tax rates for the segment were -13% and 14% for the years ended December 31, 2008 and 2007, respectively. The effective income tax rate for the year ended December 31, 2008, was lower than the U.S. statutory rate primarily due to additional U.S. foreign tax credits resulting from the second quarter 2008 enactment of legislation to increase the Brazilian tax rate, taxes on our share of earnings generated from our equity method investments being reflected in net investment income and the lower tax rates of foreign jurisdictions. The Brazilian tax rate change caused a one-time increase in the net deferred tax liabilities within our equity method investment during the second quarter that was offset by U.S. foreign tax credits, which reduced income tax expenses. There was no total impact to operating earnings. The effective income tax rate for the year ended December 31, 2007, was lower than the U.S. statutory rate

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primarily due to taxes on our share of earnings generated from our equity method investments that are included in net investment income and the lower tax rates of foreign jurisdictions.

### *Year Ended December 31, 2007 Compared to Year Ended December 31, 2006*

#### **Operating Earnings**

Operating earnings increased \$19.5 million primarily due to higher earnings from our equity method investments in Brazil and China and the strengthening of the Brazilian real versus the U.S. dollar. Operating earnings in Chile and Hong Kong increased primarily due to higher annualized investment yields in Chile and growth in AUM in Hong Kong and Chile.

#### **Operating Revenues**

Premiums in Chile increased \$31.0 million primarily due to higher sales of single premium annuities with life contingencies. This increase was partially offset by a \$23.7 million decrease in Mexico resulting from lower sales of single premium annuities with life contingencies due to our decision to not sell these annuities in Mexico in 2007 due to unfavorable market conditions.

Fees and other revenues in our Hong Kong, Chile and India operations increased primarily due to growth in AUM in these countries. In addition, fees and other revenues increased in Hong Kong due to performance-based fees.

Net investment income increased primarily due to a higher annualized yield on average invested assets and cash, excluding our equity method investments, and to a lesser extent due to a \$418.0 million increase in average invested assets and cash, excluding our equity method investments, coupled with higher earnings from our equity method subsidiaries in Brazil, China and Malaysia. The annualized yield on average invested assets and cash, excluding our equity method investments, was 10.3% for the year ended December 31, 2007, compared to 7.1% for the year ended December 31, 2006.

#### **Total Expenses**

Benefits, claims and settlement expenses increased \$152.1 million in Chile, primarily due to higher interest crediting rates in 2007 and increased sales of single premium annuities with life contingencies.

Operating expenses within our Mexican operations decreased \$20.9 million primarily due to the unlocking of assumptions surrounding PVFP related to newly enacted legislation of the mandatory privatized social security system. This decrease was partially offset by higher operating expenses in our other international operations due to continued growth.

#### **Income Taxes**

The effective income tax rates for the segment were 14% and -16% for the years ended December 31, 2007 and 2006, respectively. The effective income tax rate for the year ended December 31, 2007, was lower than the U.S. statutory rate primarily due to taxes on our share of earnings generated from our equity method investments that are included in net investment income and the lower tax rates of foreign jurisdictions. The effective income tax rate for the year ended December 31, 2006, was lower than the U.S. statutory rate, primarily due to tax refinements in Mexico and Chile and taxes on our share of earnings generated from our equity method investments that are included in net investment income.

#### **Life and Health Insurance Segment**

##### *Individual Life Insurance Trends*

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

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

For the year ended	Universal and variable universal life insurance Fee revenues	Traditional life insurance Premiums
	<i>(in millions)</i>	
December 31, 2008	\$ 338.8	\$ 591.7
December 31, 2007	282.6	611.7
December 31, 2006	225.3	624.4

The following table provides a summary of our individual life insurance policyholder liabilities for the years indicated:

As of	Universal and variable universal life insurance Policyholder liabilities(1)	Traditional life insurance Policyholder liabilities
	<i>(in millions)</i>	
December 31, 2008	\$ 4,692.5	\$ 5,856.7
December 31, 2007	4,544.2	5,910.9
December 31, 2006	3,948.6	5,921.5

(1)

Includes separate account liabilities for policies with variable investment options.

### Health Insurance Trends

In our health insurance and fee-for-service businesses, we continue to experience membership declines due to lower sales and higher lapses.

Our health insurance premium and fees were as follows for the years indicated:

For the year ended	Premium and fees Group medical insurance	Fee-for-service
	<i>(in millions)</i>	
December 31, 2008	\$ 1,617.0	\$ 143.0
December 31, 2007	1,808.7	167.3
December 31, 2006	1,861.4	172.5

Our covered medical members were as follows for the years indicated:

As of	Covered medical members Group medical insurance	Fee-for-service
	<i>(in thousands)</i>	
December 31, 2008	449.3	543.9
December 31, 2007	566.1	669.2
December 31, 2006	642.5	758.0

### Specialty Benefits Insurance Trends

Premium and fee growth for the individual disability line of our specialty benefits insurance business is being driven by solid sales and retention, while growth of the group lines has slowed compared to prior years as we maintain pricing discipline in a very competitive environment.



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

For the year ended	Group dental and vision insurance	Premium and fees		
		Group life insurance	Group disability insurance	Individual disability insurance
		<i>(in millions)</i>		
December 31, 2008	\$ 557.3	\$ 348.2	\$ 303.5	\$ 172.6
December 31, 2007	541.0	344.2	304.6	160.0
December 31, 2006	496.3	310.4	254.9	141.6

### *Life and Health Insurance Segment Summary Financial Data*

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

The following table presents certain summary financial data relating to the Life and Health Insurance segment for the years indicated:

	For the year ended December 31,			Increase (decrease)	
	2008	2007	2006	2008 vs. 2007	2007 vs. 2006
	<i>(in millions)</i>				
Operating revenues:					
Premiums and other considerations	\$ 3,476.1	\$ 3,671.6	\$ 3,598.7	\$ (195.5)	\$ 72.9
Fees and other revenues	528.9	495.4	444.2	33.5	51.2
Net investment income	677.0	690.1	693.3	(13.1)	(3.2)
Total operating revenues	4,682.0	4,857.1	4,736.2	(175.1)	120.9
Expenses:					
Benefits, claims and settlement expenses	2,909.0	3,110.2	2,910.3	(201.2)	199.9
Dividends to policyholders	265.7	290.1	290.3	(24.4)	(0.2)
Operating expenses	1,104.7	1,129.5	1,110.8	(24.8)	18.7
Total expenses	4,279.4	4,529.8	4,311.4	(250.4)	218.4
Operating earnings before income taxes	402.6	327.3	424.8	75.3	(97.5)
Income taxes	132.2	106.2	142.3	26.0	(36.1)
Operating earnings	\$ 270.4	\$ 221.1	\$ 282.5	\$ 49.3	\$ (61.4)

### *Year Ended December 31, 2008 Compared to Year Ended December 31, 2007*

#### **Operating Earnings**

Operating earnings in our health insurance business increased \$27.6 million primarily due to favorable prior year claim developments in 2008 compared to unfavorable prior year claim development in 2007. At the end of a reporting period, we recognize a liability for the estimate of claims incurred but not reported. In subsequent periods, an adjustment to prior period claim development is made to reflect actual or updated estimates of incurred claims. Operating earnings in our specialty benefits insurance business increased \$18.3 million, primarily due to favorable claims experience in our disability businesses. Operating earnings in our individual life insurance business increased \$3.4 million due to updating the dividend scale to reflect the experience of the Closed Block and growth in the business, partially offset by an increase in DPAC amortization.

#### **Operating Revenues**

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Premiums decreased \$189.1 million in our health insurance business, as a reduction in average covered medical members was partially offset by an increase in premium per member. Premiums decreased \$36.9 million in our individual life insurance business due to the expected continued decline from the decreasing block of traditional life insurance business. These decreases were partially offset by a \$30.5 million increase in our specialty benefits insurance business due to growth in the individual disability line of business and dental trend (premium increase resulting from higher costs and utilization).

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Fees and other revenues increased \$58.6 million in our individual life insurance business due to growth in the universal life and variable universal life lines of business. This increase in fees more than offset the decline in individual life insurance premiums. Partially offsetting this increase in fees and other revenues was a \$26.9 million decrease in our health insurance business, largely due to a change in classification in 2008 of the reimbursement of certain pass-through expenses, which removed them from both fee revenues and operating expenses, and a decrease in average fee-for-service medical members.

### **Total Expenses**

Benefits, claims and settlement expenses decreased \$216.2 million in our health insurance business due to a decrease in average covered medical members and favorable prior period claim development in 2008 compared to unfavorable prior year claim development in 2007.

Dividends to policyholders decreased \$24.4 million, primarily from updating the policyholder dividend scale to reflect the experience of the Closed Block.

Operating expenses decreased \$53.2 million in our health insurance business due to actively managing to lower expenses associated with a decline in insured medical and fee-for-service members and due to a change in classification in 2008 of the reimbursement of certain pass-through expenses, removing them from both fee revenues and operating expenses. Partially offsetting this decrease was a \$15.9 million increase in our individual life insurance business primarily related to higher DPAC amortization due to reduced equity market performance and worse mortality experience. Individual life insurance operating expenses also increased due to sales growth. Additionally, operating expenses increased \$12.0 million in our specialty benefits insurance business in line with moderate growth in the business.

### **Income Taxes**

The effective income tax rates for the segment were 33% and 32% for the years ended December 31, 2008 and 2007, respectively. The effective income tax rates were lower than the U.S. statutory rate as a result of interest exclusion from taxable income and income tax deductions allowed for corporate dividends received.

### ***Year Ended December 31, 2007 Compared to Year Ended December 31, 2006***

### **Operating Earnings**

Operating earnings in our health insurance business decreased \$47.7 million due to increases in the cost of medical care, unfavorable prior year claim developments and an overall decline in covered members. These increases in cost were partially offset by increases in premium per member and lower operating expense ratios in our health insurance business. Operating earnings in our individual life insurance business decreased \$18.8 million, due to favorable DPAC adjustments in 2006 compared to unfavorable DPAC adjustments in 2007, coupled with a decrease in investment income from a lower asset base related to capital reductions, which more than offset growth in the universal life and variable universal life businesses. Operating earnings in our specialty benefits insurance business increased \$5.1 million, as growth in premiums and improvement in expense ratios were partially offset by higher loss ratios.

### **Operating Revenues**

Premiums increased \$149.0 million in our specialty benefits insurance business primarily due to growth in the business resulting from solid sales and retention in all product lines. Premiums decreased \$52.7 million in our health insurance business as a reduction in covered members was partially offset by an increase in premium per member. Furthermore, premiums decreased \$23.4 million in our individual life insurance business due to the expected continued decline from the decreasing block of traditional life insurance business.

Fees and other revenues increased \$59.7 million in our individual life insurance business due to growth in the universal life and variable universal life lines of business. This increase in fees more than offset the decline in individual life insurance premiums.

### **Total Expenses**

Benefits, claims and settlement expenses increased \$132.4 million in our specialty benefits insurance business primarily due to growth in the business. Benefits, claims and settlement expenses increased \$51.2 million in our health insurance business, as higher claims costs per member and unfavorable prior year claim development were partially offset by a decrease in covered members.

Operating expenses increased \$40.1 million in our individual life insurance business primarily due to an increase in DPAC amortization, which was largely the result of unfavorable unlocking relative to 2006 and higher amortization in 2007 due to growth in the business and higher lapses early in the year. Operating expenses increased \$14.8 million in our specialty benefits insurance business due to continued growth in the business. Operating expenses decreased





\$36.2 million in our health insurance business primarily due to staff and other reductions associated with the decline in insured medical and fee-for-service medical covered members.

## Income Taxes

The effective income tax rates for the segment were 32% and 33% for the years ended December 31, 2007 and 2006, respectively. The effective income tax rates were lower than the U.S. statutory rate as a result of interest exclusion from taxable income and income tax deductions allowed for corporate dividends received.

## Corporate Segment

### Corporate Segment Summary Financial Data

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

	For the year ended December 31,			Increase (decrease)	
	2008	2007	2006	2008 vs. 2007	2007 vs. 2006
	<i>(in millions)</i>				
Operating revenues:					
Total operating revenues	\$ (202.8)	\$ (156.8)	\$ (110.9)	\$ (46.0)	\$ (45.9)
Expenses:					
Total expenses	(113.2)	(120.8)	(94.9)	7.6	(25.9)
Operating loss before income taxes and preferred stock dividends	(89.6)	(36.0)	(16.0)	(53.6)	(20.0)
Income tax benefits	(42.9)	(31.3)	(21.7)	(11.6)	(9.6)
Preferred stock dividends	33.0	33.0	33.0		
Operating loss	\$ (79.7)	\$ (37.7)	\$ (27.3)	\$ (42.0)	\$ (10.4)

### Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

#### Operating Loss

Operating loss increased primarily due to a decline in average annualized investment yields and to a smaller extent by a decrease in average invested assets for the segment. The decline in average annualized investment yields was primarily due to a decrease in earnings from equity real estate investments and an increase in losses from certain equity method partnership interests.

#### Operating Revenues

Operating revenues decreased due to a decline in average annualized investment yields, resulting mostly from above average gains on equity real estate sales activity in the prior year, as well as lower earnings on certain equity method partnership interests where the underlying assets are marked to market. In addition, operating revenues decreased due to lower average invested assets for the segment. These decreases were offset in part by lower investment expenses due to the unwinding of our variable interest in a synthetic fuel production facility in 2008, as well as a decrease in inter-segment eliminations included in this segment, which was offset by a corresponding change in total expenses.

#### Total Expenses

Total expenses increased due to higher interest expense related to federal income tax activities and interest expense on corporate debt. In addition, total expenses increased due to a decrease in inter-segment eliminations included in this segment, which was offset by a corresponding change in operating revenues. These increases were partially offset by a decline in amounts credited to employee accounts in a nonqualified defined contribution pension plan.

## Income Taxes

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Income tax benefits increased due to an increase in operating loss before income taxes. Also contributing to the increased income tax benefits was the release of state deferred income tax liabilities associated with the reorganization of certain subsidiaries in 2008. The increased income tax benefits were offset in part by the reduction of synthetic fuel tax credits due to their expiration as of December 31, 2007.

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*Year Ended December 31, 2007 Compared to Year Ended December 31, 2006*

### **Operating Loss**

Operating loss increased primarily due to higher interest expense, largely related to the issuance of corporate debt in the fourth quarter of 2006, partially offset by higher annualized investment yields driven by the joint venture real estate portfolio.

### **Operating Revenues**

Operating revenues decreased primarily due to an increase in inter-segment eliminations included in this segment, which was offset by a corresponding change in total expenses. This decrease was partially offset by an increase in average annualized investment yields driven by the joint venture real estate portfolio.

### **Total Expenses**

Total expenses decreased primarily due to an increase in inter-segment eliminations included in this segment, which was offset by a corresponding change in operating revenues. This decrease was partially offset by an increase in interest expense on corporate debt and interest expense related to federal income tax activities.

### **Income Taxes**

Income tax benefits increased primarily due to an increase in operating loss before income taxes.

### **Liquidity and Capital Resources**

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

#### ***Liquidity***

Our liquidity requirements have been and will continue to be met by funds from consolidated operations as well as the issuance of commercial paper, common stock, debt or other capital securities and borrowings from credit facilities. We believe that cash flows from these sources are sufficient to satisfy the current liquidity requirements of our operations, including reasonably foreseeable contingencies. However, there can be no assurance that future experience regarding benefits and surrenders will be similar to historic experience or our forecasts of reasonably possible liquidity scenarios, since benefits and surrender levels are influenced by such factors as the interest rate environment, our claims paying ability and our financial strength ratings.

We maintain a level of cash and securities which, combined with expected cash inflows from investments and operations, is believed to be adequate to meet anticipated short-term and long-term benefit and expense payment obligations. However, withdrawal and surrender levels may differ from anticipated levels for a variety of reasons. In the event our current internal sources of liquidity do not satisfy our needs, we may have to seek additional financing and, in such case, we may not be able to successfully obtain additional financing on favorable terms, or at all.

With the uncertainty surrounding the length and severity of the current global recession, we believe it is prudent capital management to continue to explore any and all options available to us to maximize capital flexibility, including accessing the capital markets, utilizing our

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commercial paper program, cost cutting and internal efficiency initiatives, U.S. government sources of funding and transactions with strategic and other investors. Disruptions, uncertainty or volatility in the capital and credit markets may limit our access to capital required to operate our business. Such market conditions may limit our ability to replace, in a timely manner, maturing liabilities; satisfy statutory capital requirements; fund redemption requests on insurance or other financial products; generate fee income and market-related revenue to meet liquidity needs and access the capital necessary to grow our business. As such, we may be forced to delay raising capital, issue shorter tenor securities than we prefer, utilize available internal resources or bear an unattractive cost of capital which could decrease our profitability and significantly reduce our financial flexibility and liquidity. We will closely

monitor market opportunities to issue securities at favorable terms, explore other capital raising transactions, and continue to follow developments of government programs.

Despite the fact that approximately \$19.1 billion, or 98%, of our institutional GICs and funding agreements cannot be redeemed by contractholders prior to maturity and that our life insurance and annuity liabilities contain provisions limiting early surrenders, given market conditions we have built additional liquidity by increasing cash and cash equivalent holdings to \$2.6 billion as of December 31, 2008. Actions to increase liquidity and manage capital include: (i) investing new cash flows into more liquid securities, (ii) reducing our common stock dividend from prior year levels to \$0.45 per share and (iii) suspending purchases of our common stock under the existing share repurchase authorization, effective October 13, 2008. Currently, new cash inflows are primarily being invested in cash, short-term government-backed securities and other liquid investments. As a result of increased cash holdings, current yields will be lower than historically experienced. This trend will continue as long as market conditions remain strained and we continue to invest new cash inflows in cash and liquid investments.

As a savings and loan holding company subject to oversight of the Office of Thrift Supervision, we have applied to participate in TCPP. If we participate in TCPP, we would issue preferred shares and warrants to the Treasury. The amount for which a company can apply is prescribed by the application. We have applied for and could participate in up to \$2.0 billion under the program. As a diversified financial services company providing investment, banking, retirement and insurance products to businesses and individuals, the company is a significant provider of credit and liquidity to U.S. corporate and consumer markets. Receipt of TCPP proceeds would allow us to continue to fulfill that role by supporting our ongoing organic growth needs, including Principal Bank, our federal savings bank subsidiary.

If we were to participate in the TCPP, we would be subject to certain limitations. Prior to the third anniversary of our participation, unless we had redeemed all of the preferred stock issued under the TCPP or the U.S. Treasury had transferred all of the preferred stock to a third party, the consent of the U.S. Treasury would be required for us to, among other things, increase our common stock dividend or repurchase our common stock or other preferred stock (with certain exceptions, including the repurchase of our common stock to offset share dilution from equity-based employee compensation awards).

PFS was accepted for the Federal Reserve's Commercial Paper Funding Facility ("CPFF"). The CPFF is intended to serve as a funding backstop to facilitate the issuance of term commercial paper by eligible issuers. Through CPFF, the Federal Reserve Bank of New York will finance the purchase of unsecured and asset-backed highly rated, U.S.-dollar denominated, three-month commercial paper from eligible issuers through its primary dealers. The facility has been recently extended and is now expected to expire on October 31, 2009. Our available funding under the CPFF is approximately \$233.0 million, and as of December 31, 2008, PFS had used its available capacity under the CPFF.

As of December 31, 2008, we had credit facilities with various financial institutions in an aggregate amount of \$792.4 million. As of December 31, 2008 and 2007, we had \$500.9 million and \$290.8 million of outstanding borrowings related to our credit facilities, with zero and \$30.3 million of assets pledged as support, respectively. Assets pledged consisted primarily of commercial mortgages and securities. Our credit facilities include a \$600.0 million commercial paper program, of which we issued \$482.3 million as of December 31, 2008, \$233.0 million of which was issued under the Federal Reserve's CPFF. Our commercial paper program has a back-stop facility to provide 100% support for our commercial paper program, of which there were no outstanding balances as of December 31, 2008. On October 5, 2008, Lehman Commercial Paper Inc. ("LCP"), a subsidiary of Lehman Brothers Holdings Inc., filed for protection under Chapter 11 of the Federal Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York. LCP is a lender under our credit facilities and had committed to provide \$21.0 million under each facility. We are uncertain whether LCP will fulfill its commitments under the credit facilities in light of its bankruptcy filing.

**The Holding Companies: Principal Financial Group, Inc. and Principal Financial Services, Inc.** The principal sources of funds available to our parent holding company, PFG, to meet its obligations, including the payments of dividends on common stock, debt service and the repurchase of stock, are dividends from subsidiaries as well as its ability to borrow funds at competitive rates and raise capital to meet operating and growth needs. Dividends from Principal Life, our primary subsidiary, are limited by Iowa law. Under Iowa laws, Principal Life may pay dividends only from the earned surplus arising from its business and must receive the prior approval of the Insurance Commissioner of the State of Iowa ("the Commissioner") to pay a stockholder dividend if such a stockholder dividend would exceed certain statutory limitations. In general, the current statutory limitation is the greater of (i) 10% of Principal Life's statutory policyholder surplus as of the previous year-end or (ii) the statutory net gain from operations from the previous calendar year.

Iowa law gives the Commissioner discretion to disapprove requests for dividends in excess of these limits. Based on this limitation and 2008 statutory results, Principal Life could pay approximately \$651.3 million in stockholder dividends in 2009 without exceeding the statutory limitation.

Principal Life could have paid approximately \$686.5 million in statutory dividends in 2008 based on its 2007 statutory financial results without being subject to the restrictions on payment of stockholder dividends. Total stockholder dividends paid by Principal Life to its parent company in 2008 were \$5.5 million, which consisted of a non-cash dividend of an equity method investment.



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Principal Life could have paid approximately \$660.4 million in statutory dividends in 2007 based on its 2006 statutory financial results without being subject to the restrictions on payment of stockholder dividends. Total stockholder dividends paid by Principal Life to its parent company in 2007 were \$650.0 million.

Principal Life could have paid approximately \$630.7 million in statutory dividends in 2006 based on its 2005 statutory financial results without being subject to the restrictions on payment of stockholder dividends. The ordinary stockholder dividends paid by Principal Life to its parent company in 2006 were \$426.2 million. In addition, Principal Life requested and received permission from the Commissioner to pay an extraordinary dividend in the amount of \$750.0 million. The extraordinary stockholder dividends paid by Principal Life to its parent in 2006 were \$750.0 million.

**Operations.** Our primary consolidated cash flow sources are premiums from life and health insurance products, pension and annuity deposits, asset management fee revenues, administrative services fee revenues, income from investments and proceeds from the sales or maturity of investments. Cash outflows consist primarily of payment of benefits to policyholders and beneficiaries, income and other taxes, current operating expenses, payment of dividends to policyholders, payments in connection with investments acquired, payments made to acquire subsidiaries, payments relating to policy and contract surrenders, withdrawals, policy loans, interest expense and repayment of short-term debt and long-term debt. Our investment strategies are generally intended to provide adequate funds to pay benefits without forced sales of investments. For a discussion of our investment objectives, strategies and a discussion of duration matching, see "Investments" as well as Item 7A. "Quantitative and Qualitative Disclosures about Market Risk – Interest Rate Risk."

**Cash Flows.** Activity, as reported in our consolidated statements of cash flows, provides relevant information regarding our sources and uses of cash. The following discussion of our operating, investing and financing portions of the cash flows excludes cash flows attributable to our discontinued operations, which were as follows:

	For the year ended December 31,		
	2008	2007	2006
<b>Cash flows attributable to discontinued operations:</b>			
		<i>(in millions)</i>	
Net cash provided by operating activities	\$	\$ 2.5	\$ 1.9
Net cash used in investing activities		(1.3)	(3.4)
Net cash used in financing activities		(0.5)	(0.6)

Net cash provided by operating activities was \$2,224.8 million, \$2,960.0 million and \$2,275.5 million for the years ended December 31, 2008, 2007 and 2006, respectively. As an insurance business, we typically generate positive cash flows from operating activities, as premiums collected from our insurance products and income received from our investments exceed policy acquisition costs, benefits paid, redemptions and operating expenses. These positive cash flows are then invested to support the obligations of our insurance and investment products and required capital supporting these products. Our cash flows from operating activities are affected by the timing of premiums, fees, and investment income received and expenses paid. The decrease in cash provided by operating activities in 2008 compared to 2007 was primarily the result of the fluctuations in receivables and payables associated with timing of settlements. The increase in cash provided by operating activities in 2007 compared to 2006 was primarily related to fluctuations in operational receivables and payables.

Net cash used in investing activities was \$2,917.2 million, \$4,499.2 million and \$3,910.4 million for the years ended December 31, 2008, 2007 and 2006, respectively. The decrease in cash used in investing activities was primarily the result of a decrease in net purchases of investments as we have held and are holding higher cash balances to cover potential near term obligations and to further reposition our investment portfolio as necessary. The increase in cash used in investing activities in 2007 compared to 2006 was primarily due to an increase in net purchases of mortgage loans, available-for-sale securities and real estate as well as additional contributions in 2007 to an equity method investment with no corresponding activity in 2006. This increase was partially offset by larger acquisitions in 2006 relative to 2007.

Net cash provided by financing activities was \$1,956.0 million, \$1,292.1 million and \$1,586.5 million for the years ended December 31, 2008, 2007 and 2006, respectively. The increase in cash provided by financing activities in 2008 compared to 2007 is primarily due to our actions to increase liquidity and manage capital risk via a reduction in the acquisition of treasury stock as well as the reduction of our common stock dividend from prior year levels. The decrease in cash provided by financing activities in 2007 compared to 2006 was primarily due to the issuance of \$600.0 million of senior notes from our shelf registration in 2006, with no corresponding activity in 2007 as well as a decrease in net deposits of investment contracts, offset in part by proceeds from short-term debt in the current year, compared to payments of short-term debt in the previous year. We will have \$454.9 million of long-term debt due in 2009; our plan is to refinance this debt. We have applied to participate in the FDIC Temporary Liquidity Guarantee Program ("TLGP") program. If we do not qualify for the FDIC TLGP, we may not be able to issue debt into the capital markets on terms that are favorable to us or at all due to, among other things, the continuing disruptions in the financial markets and/or investor preference for debt issued by participants in the TLGP. If the public debt markets are not accessible to us, we believe that we have several options to refinance this debt, including: use of our commercial paper program, reduction of our common dividend, or a dividend of excess liquidity from Principal Life, funded by either cash or selling cash





equivalents. In the event that no debt sources are available to refinance the \$454.9 million of long-term debt, we may have to recognize a gain or loss on certain interest rate hedges. For more information regarding the derivatives, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 8, Derivative Financial Instruments" under the caption, "Cash Flow Hedges."

**Shelf Registration.** We currently have an effective shelf registration which allows us the ability to issue, in unlimited amounts, unsecured senior debt securities or subordinated debt securities, junior subordinated debt, preferred stock, common stock, warrants, depository shares, stock purchase contracts and stock purchase units of PFG, trust preferred securities of three subsidiary trusts and guarantees by PFG of these trust preferred securities. Our wholly owned subsidiary, PFS, may guarantee, fully and unconditionally or otherwise, our obligations with respect to any non-convertible securities, other than common stock, described in the shelf registration. For information on senior notes issued from our shelf registration, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 12, Debt."

**Short-Term Debt and Long-Term Debt.** For debt information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 12, Debt."

**Stockholders' Equity.** Proceeds from the issuance of our common stock were \$36.4 million, \$73.6 million and \$66.2 million in 2008, 2007 and 2006, respectively.

The following table summarizes our return of capital to common stockholders in 2008, 2007 and 2006.

	For the year ended December 31,		
	2008	2007	2006
	(in millions)		
Dividends to stockholders	\$ 116.7	\$ 235.6	\$ 214.7
Repurchase of common stock	6.4	756.3	755.8
Total cash returned to stockholders	\$ 123.1	\$ 991.9	\$ 970.5

Number of shares repurchased	1.0	11.5	14.5
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To enhance our liquidity and capital position in the current market, our Board of Directors decided to suspend repurchases of our common stock under our stock repurchase program and reduce our common stock dividend from prior year levels. The resumption of our stock repurchase program and the declaration and payment of future dividends to the holders of our common stock will be at the discretion of our Board of Directors and will depend on many factors including dividends from our operating subsidiaries, our financial condition and net income, the capital requirements of our subsidiaries, legal requirements, regulatory constraints, our credit and financial strength ratings and such other factors as the Board of Directors deems relevant.

For additional stockholders' equity information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 16, Stockholders' Equity."

### Capitalization

Our capital structure as of December 31, 2008 and 2007, consisted of debt and equity summarized as follows:

	December 31,	
	2008	2007
	(in millions)	
Debt:		
Short-term debt	\$ 500.9	\$ 290.8
Long-term debt	1,290.5	1,398.8
Total debt	1,791.4	1,689.6
Stockholders' equity:		
Equity excluding accumulated other comprehensive income	7,384.4	7,001.5
Total capitalization excluding accumulated other comprehensive income	\$ 9,175.8	\$ 8,691.1

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Debt to equity excluding accumulated other comprehensive income	<b>24%</b>	24%
Debt to capitalization excluding accumulated other comprehensive income	<b>20%</b>	19%

As of December 31, 2008, between the life and the holding companies, we had approximately \$800.0 million of capital in excess of levels needed to maintain our current credit rating. In addition to the previously mentioned suspension of share repurchases and the adjustment of the current year common stock dividend, we are taking other actions to maximize internally generated capital, above and beyond what is currently being generated from ongoing operations. This includes: managing growth of capital intensive businesses and new expense initiatives, including limitations on new hiring, reducing 2009 merit increases by more than 75%, and the reduction of approximately 550 existing positions. We expect these efforts to be a source of additional capital over the next several quarters. Excess capital levels will help position us to capitalize on organic growth and acquisition opportunities.

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## Contractual Obligations

The following table presents payments due by period for long-term contractual obligations as of December 31, 2008:

Contractual Obligations (1)	Total Payments	Payments due in year ending			
		2009	2010-2011 (in millions)	2012-2013	2014 and thereafter
Contractholder funds (2)	\$ 61,476.0	\$ 7,898.5	\$ 11,829.0	\$ 13,560.3	\$ 28,188.2
Future policy benefits and claims (3)	39,492.7	2,084.6	3,475.5	3,341.2	30,591.4
Long-term debt (4)	1,290.5	466.5	92.5	17.5	714.0
Certificates of deposit (5)	1,272.4	1,029.6	170.7	69.6	2.5
Other long-term liabilities (6)	1,315.8	1,102.1			213.7
Capital leases	11.5	5.7	5.6	0.2	
Long-term debt interest	1,338.3	74.2	97.5	95.5	1,071.1
Operating leases (7)	198.5	53.9	73.8	34.8	36.0
Purchase obligations (8)	226.4	189.8	30.0	6.6	
Total contractual obligations	\$ 106,622.1	\$ 12,904.9	\$ 15,774.6	\$ 17,125.7	\$ 60,816.9

- (1) Excludes short-term liabilities, other policyholder funds, taxes and short-term debt as these are not long-term and/or not contractual in nature. Also excludes obligations under our pension and other postretirement benefit plans as we do not anticipate contributions will be needed to satisfy the minimum funding requirements of ERISA for our qualified pension plan. In addition, separate account liabilities are excluded. Separate account liabilities represent the fair market value of funds that are separately administered by us. Generally, the separate account contract owner, rather than us, bears the investment risk of these funds. The separate account liabilities are legally segregated and are not subject to claims that arise out of any other business of ours. Net deposits, net investment income and realized and unrealized capital gains and losses on the separate accounts are not reflected in the consolidated statement of operations. The separate account obligations will be fully funded by cash flows from the separate account assets.
- (2) Includes GICs, funding agreements, individual fixed annuities, universal life insurance and other investment-type contracts. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 11, Insurance Liabilities" for additional information.
- Amounts included in the contractholder funds line item reflect estimated cash payments to be made to policyholders. The sum of the cash outflows shown for all years in the table exceeds the corresponding liability amount included in our consolidated financial statements as of December 31, 2008. The liability amount in our consolidated financial statements reflects estimated cash payments to policyholders, assumptions with regard to the timing of cash payments and discounting for interest.
- (3) Amounts included in the future policy benefits and claims line item reflect estimated cash payments to be made to policyholders. The sum of the cash outflows shown for all years in the table exceeds the corresponding liability amount included in our consolidated financial statements as of December 31, 2008. The liability amount in our consolidated financial statements reflects estimated cash payments to policyholders, reductions for expected future premiums, assumptions with regard to the timing of cash payments and discounting for interest.
- (4) For long-term debt information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 12, Debt."
- (5) Amounts included in the certificates of deposit line item reflect estimated cash payments to be made, including expected interest payments. Certificates of deposit are reported as other liabilities on our consolidated statement of financial position.
- (6) Other long-term liabilities include other liabilities reflected in the consolidated statement of financial position that are contractual, non-cancelable and long-term in nature. The total payments primarily related to checking and savings deposits. This line item excludes

accruals, short-term items and items not contractual in nature.

(7)

As a lessee, we lease office space, data processing equipment and office furniture and equipment under various operating leases.

(8)

Purchase obligations include material contracts where we have a non-cancelable commitment to purchase goods and services in addition to commitments to originate loans and purchase investments.

### ***Pension and Other Postretirement Plan Funding***

We have defined benefit pension plans covering substantially all of our U.S. employees and certain agents. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 14, Employee and Agent Benefits" for a complete discussion of these plans and their effect on the consolidated financial statements.

We report the net funded status of our pension and other postretirement plans in the Consolidated Statements of Financial Condition as a component of accumulated other comprehensive income in stockholders' equity. It represents the differences between the fair value of plan assets and the projected benefit obligation for pension plans and the accumulated postretirement benefit obligation for other postretirement plans that have not yet been recognized as a component of net periodic cost. The measurement of the net funded status can vary based upon the fluctuations in the fair value of the plan assets and the actuarial assumptions used for the plans as discussed below. The net underfunded status of the pension and other post-retirement benefit obligation at December 31, 2008, was \$404.8 million pre-tax, a decrease of \$881.9 million from a net funded status of \$477.1 million pre-tax at December 31, 2007. The decline in the net funded status of the pension and other postretirement benefit obligation in 2008 is primarily related to market conditions experienced in 2008.

Our funding policy for the qualified pension plan is to fund the plan annually in an amount at least equal to the minimum annual contributions required under ERISA and, generally, not greater than the maximum amount that can be deducted for federal income tax purposes. We do not anticipate contributions will be needed to satisfy the minimum funding requirements of ERISA for our qualified pension plan. At this time, it is too early to estimate the amount that may be contributed, but it is possible that we may fund the plans in 2009 in the range of \$20-\$50 million. This includes funding for both our qualified and nonqualified pension plans. We may contribute to our other postretirement benefit plans in 2009 pending further analysis.

### ***Contractual Commitments***

In connection with our banking business, we make additional commitments to extend credit, which are agreements to lend to a customer as long as there is no violation of any conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A majority of these commitments are lines of credit and are expected to expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash funding requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The total commitments to fund loans were \$193.8 million as of December 31, 2008.

We have made commitments to fund certain limited partnerships in which we are a limited partner. As of December 31, 2008, the amount of unfunded commitments was \$90.6 million. We are only required to fund additional equity under these commitments when called upon to do so by the general partner, therefore these commitments are not liabilities on our consolidated statements of financial position.

### ***Off-Balance Sheet Arrangements***

***Variable Interest Entities.*** We have relationships with various types of special purpose entities and other entities where we have a variable interest as described in Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 5, Variable Interest Entities." We do not have a direct or contingent obligation related to our unconsolidated variable interest entities ("VIE") other than described below.

***Retained Interests in Securitized Assets.*** Previously, we, along with other contributors, sold commercial mortgage loans in securitization transactions to trusts. As these trusts are classified as qualifying special purpose entities, they are not subject to the VIE consolidation rules. We may retain interests in the securitization transactions. At December 31, 2008 and 2007, the fair values of retained interests related to the securitizations of commercial mortgage loans were \$133.2 million and \$315.8 million, respectively. The investors and the securitization entities have no recourse to our assets for failure of debtors to pay when due. The value of our retained interests is subject primarily to credit risk. During the third quarter of 2008, we made a decision to terminate our commercial mortgage securities issuance operation.

***Guarantees and Indemnifications.*** For guarantee and indemnification information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 15, Contingencies, Guarantees and Indemnifications" under the caption, "Guarantees and Indemnifications."

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

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

NRSROs publish financial strength ratings on U.S. life insurance companies that are indicators of an insurance company's ability to meet contractholder and policyholder obligations. NRSROs also assign credit ratings on non-life



insurance entities, such as PFG and PFS. Credit ratings are indicators of a debt issuer's ability to meet the terms of debt obligations in a timely manner, and are important factors in overall funding profile and ability to access external capital. Such ratings are not a recommendation to buy, sell or hold securities. Ratings are subject to revision or withdrawal at any time by the assigning NRSRO, and each rating should be evaluated independently of any other rating.

Ratings are important factors in establishing the competitive position of insurance companies and maintaining public confidence in products being offered. A ratings downgrade, or the potential for such a downgrade, could, among other things: (i) materially increase the number of surrenders for all or a portion of the net cash values by the owners of policies, contracts, general account GICs we have issued, and materially increase the number of withdrawals by policyholders of cash values from their policies; (ii) result in the termination of our relationships with broker-dealers, banks, agents, wholesalers and other distributors of our products and services; (iii) reduce new sales, particularly with respect to general account GICs and funding agreements purchased by pension plans and other institutions; (iv) cause some of our existing liabilities to be subject to acceleration, additional collateral support, changes in terms, or creation of additional financial obligations and (v) increase our cost of capital and limit our access to the capital markets. Any of these consequences could adversely affect our profitability and financial condition.

In recent months, each of A.M. Best Company, Inc., Fitch Ratings Ltd., Moody's Investors Service, and Standard & Poor's has revised its outlook for the U.S. life insurance industry from stable to negative. Of the many issues cited, the negative outlook is primarily based on expectations for higher-than-normal credit losses, negative impact of the volatile equity market on earnings and reduced financial flexibility.

These outlook revisions signal increased review of U.S. life insurance companies by A.M. Best Company, Inc., Fitch Ratings, Ltd., Moody's Investors Service, and Standard & Poor's. As a result, it is possible there will be changes in the benchmarks for capital, liquidity, earnings and other factors used by these NRSROs that are critical to a ratings assignment at a particular rating level. If any such changes are made, it is possible that such changes could have an impact on the ratings of U.S. life insurance companies, including ours, which could adversely impact our profitability and financial condition.

As a reflection of the change by the rating agencies of their view of the market and the impact on life insurance companies, on February 10, 2009, Moody's Investors Service affirmed Principal Life's insurance financial strength rating, with a negative outlook, and Standard & Poor's also affirmed Principal Life's insurance financial strength rating, with a credit watch negative outlook. While the affirmations reflect our financial strength, operating performance and ability to meet obligations, the negative and credit watch negative outlooks reflect Moody's Investors Service and Standard & Poor's expectations that equity market risk will have an impact on our earnings, and that there will be additional asset impairments. On February 13, 2009, Fitch Ratings Ltd. downgraded Principal Life's insurance financial strength rating to AA-, with a rating watch negative outlook. While the AA- rating is still considered strong, macroeconomic pressure is impacting the outlook for the rating. The following table summarizes our significant financial ratings from the major independent rating organizations:

	A.M. Best	Fitch	Standard & Poor's	Moody's
<b>Principal Financial Group</b>				
Senior Unsecured Debt			A	A3
Preferred Stock			BBB+	Baa2
<b>Principal Financial Services</b>				
Senior Unsecured Debt			A	A2
Commercial Paper			A-1	P-1
<b>Principal Life Insurance Company</b>				
Insurer Financial Strength	A+	AA-	AA	Aa2
Enterprise Risk Management Rating			Strong	

### *Impacts of Income Taxes*

For income tax information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 13, Income Taxes."

### **Fair Value Measurement**

As discussed in Item 8. "Financial Statements, Notes to Consolidated Financial Statements, Note 17, Fair Value Measurement" we adopted SFAS 157 effective January 1, 2008. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price) and establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels for disclosure purposes. The fair value hierarchy gives the highest priority (Level 1) to quoted prices in active markets for identical assets or liabilities and gives the lowest priority to unobservable





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inputs (Level 3). An asset or liability's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation. The levels of the fair value hierarchy are as follows:

**Level 1** Fair values are based on unadjusted quoted prices in active markets for identical assets or liabilities. Our Level 1 assets and liabilities primarily include exchange traded equity securities, mutual funds and U.S. Treasury bonds. Prices are obtained from readily available sources for market transactions involving identical assets or liabilities.

**Level 2** Fair values are based on inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. Observable inputs include market prices for identical or similar assets or liabilities and other market observable inputs such as interest rate, credit spread and foreign currency exchange rates observable in the marketplace or derived from market transactions. Our Level 2 assets and liabilities primarily include fixed maturity securities (including public and private bonds), equity securities, over-the-counter derivatives and other investments. These fair values are generally obtained from third-party pricing services or determined through the use of valuation models or methodologies, including matrix pricing, using substantially all observable inputs. Prices are validated through an investment analyst review process including direct interaction with external sources, recent trade activity or through the use of internal models.

**Level 3** Fair values are based on at least one significant unobservable input for the asset or liability and as a result considerable judgment may be used in determining the fair values. Our Level 3 assets and liabilities include certain fixed maturity securities, private equity securities, complex derivatives and embedded derivatives. These fair values are generally obtained through the use of valuation models or methodologies using a significant unobservable input or broker quote. In circumstances where broker quotes are used to value an instrument we generally receive one non-binding quote. Fixed maturity securities and equity securities priced using broker quotes represent 0.9% of the total and all are classified as Level 3. Broker quotes are validated through an investment analyst review process including direct interaction with external sources, through the use of internal models or other relevant information.

We did not make any significant changes to our valuation process during the year of 2008. For further information on investments and derivatives, see Item 8. "Financials Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 6, Investments, and Note 8, Derivative Financial Instruments."

Assets and liabilities measured at fair value on a recurring basis as of December 31, 2008, are summarized below.

	As of December 31, 2008				
	Assets / (liabilities) measured at fair value	Fair value hierarchy level			
		Level 1	Level 2	Level 3	
		(in millions)			
Assets					
Fixed maturities, available-for-sale	\$ 40,117.2	\$ 126.7	\$ 38,817.5	\$ 1,173.0	
Fixed maturities, trading	843.4		782.7	60.7	
Equity securities, available-for-sale	242.7	176.4	10.1	56.2	
Equity securities, trading	158.0	61.3	96.7		
Net derivative assets and liabilities	(261.3)		(95.1)	(166.2)	
Other investments	75.9	13.2	62.7		
Cash equivalents	1,807.9	656.3	1,151.6		
Sub-total excluding separate account assets	42,983.8	1,033.9	40,826.2	1,123.7	
Separate account assets	55,142.6	30,693.4	18,406.9	6,042.3	
Total assets	\$ 98,126.4	\$ 31,727.3	\$ 59,233.1	\$ 7,166.0	
Liabilities					
Investment-type insurance contracts	\$ (60.2)	\$	\$	\$ (60.2)	

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Other liabilities	(109.3)		(5.5)	(103.8)	
<b>Total liabilities</b>	<b>\$ (169.5)</b>	<b>\$</b>	<b>\$ (5.5)</b>	<b>\$ (164.0)</b>	
<b>Net assets</b>	<b>\$ 97,956.9</b>	<b>\$ 31,727.3</b>	<b>\$ 59,227.6</b>	<b>\$ 7,002.0</b>	
% of net assets			32%	61%	7%
% of net assets, excluding separate account assets			2%	95%	3%

65

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## Changes in Level 3 fair value measurements

The reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2008, is as follows:

For the year ended December 31, 2008

	Beginning asset/ (liability) balance as of January 1, 2008	Total realized/unrealized gains (losses)		Purchases, sales, issuances and settlements	Transfers in (out) of Level 3	Ending asset/ (liability) balance as of December 31, 2008	Net increase (decrease)
		Included in net income (1)	Included in other comprehensive income				
<i>(in millions)</i>							
<b>Assets</b>							
Fixed maturities, available-for-sale	\$ 2,201.3	\$ (148.5)	\$ (507.8)	\$ (567.2)	\$ 195.2	\$ 1,173.0	\$ (1,028.3)
Fixed maturities, trading	92.3	(19.1)		(11.4)	(1.1)	60.7	(31.6)
Equity securities, available-for-sale	51.1	(41.5)	(12.1)	20.7	38.0	56.2	5.1
Net derivative assets and liabilities	(8.0)	(125.3)	(23.9)	(9.0)		(166.2)	(158.2)
Separate account assets	7,313.2	(958.9)	1.0	(209.5)	(103.5)	6,042.3	(1,270.9)
<b>Liabilities</b>							
Investment-type insurance contracts	(49.3)	(58.4)	(0.1)	47.6		(60.2)	(10.9)
Other liabilities	(155.6)		70.0	(18.2)		(103.8)	51.8
<b>Net total</b>	<b>\$ 9,445.0</b>	<b>\$ (1,351.7)</b>	<b>\$ (472.9)</b>	<b>\$ (747.0)</b>	<b>\$ 128.6</b>	<b>\$ 7,002.0</b>	<b>\$ (2,443.0)</b>

(1)

Gains and losses for separate account assets do not impact net income as the change in value of separate account assets is offset by a change in value of separate account liabilities.

The decrease in the fair value of Level 3 instruments for the year ended December 31, 2008, is primarily attributed to separate account assets and fixed maturities, available-for-sale securities. The decrease in separate account assets is primarily a result of unrealized losses, which does not impact net income in the consolidated statements of operations, as the change in value of separate account assets is offset by a change in value of separate account liabilities. The decrease in fixed maturities, available-for-sale securities resulted from the settlement of certain credit collateralized debt obligations and unrealized losses recognized in other comprehensive income. Most of the fixed maturity available-for-sale securities unrealized losses included in other comprehensive income are related to corporate bonds, with lesser amounts attributed to collateralized debt obligations, commercial mortgage-backed securities and asset-backed securities.

## Investments

We had total consolidated assets as of December 31, 2008, of \$128.2 billion, of which \$59.1 billion were invested assets. The rest of our total consolidated assets are comprised primarily of separate account assets for which we do not bear investment risk. Because we generally do not bear any investment risk on assets held in separate accounts, the discussion and financial information below does not include such assets.

## Overall Composition of Invested Assets

Invested assets as of December 31, 2008, were predominantly high quality and broadly diversified across asset class, individual credit, industry and geographic location. Asset allocation is determined based on cash flow and the risk/return requirements of our products. As shown in the following table, the major categories of invested assets are fixed maturity

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securities and commercial mortgage loans. The remainder is invested in residential mortgage loans, real estate, equity securities and other assets. In addition, policy loans are included in our invested assets.

	December 31, 2008		December 31, 2007	
	Carrying amount	% of total	Carrying amount	% of total
	(\$ in millions)			
Fixed maturity securities:				
Public	\$ 28,786.7	49%	\$ 31,847.2	50%
Private	12,173.9	21	15,421.0	24
Equity securities	400.7	1	586.2	1
Mortgage loans:				
Commercial	11,279.3	19	10,763.5	17
Residential	1,834.3	3	1,896.1	3
Real estate held for sale	139.6		82.4	
Real estate held for investment	779.8	1	780.1	1
Policy loans	896.4	1	869.9	1
Other investments	2,816.6	5	2,118.6	3
 Total invested assets	 59,107.3	 100%	 64,365.0	 100%
 Cash and cash equivalents	 2,608.0		 1,344.4	
 Total invested assets and cash	 \$ 61,715.3		 \$ 65,709.4	

#### Investment Results

The following table presents the yield and investment income, excluding net realized capital gains and losses for our invested assets. We calculate annualized yields using a simple average of asset classes at the beginning and end of the reporting period.

	For the year ended December 31,			
	2008		2007	
	Yield	Amount	Yield	Amount
	(\$ in millions)			
Fixed maturity securities	7.0%	\$ 3,105.8	6.2%	\$ 2,869.2
Equity securities	3.8	18.9	3.8	27.0
Mortgage loans commercial	6.1	666.8	6.6	688.9
Mortgage loans residential	8.3	154.8	7.5	129.7
Real estate	6.1	54.6	8.9	74.9
Policy loans	6.6	58.3	6.1	52.6
Cash and cash equivalents	2.9	57.0	7.2	105.9
Other investments	0.9	21.8	9.3	165.1
 Total before investment expenses	 6.5	 4,138.0	 6.4	 4,113.3
Investment expenses	0.2	(143.7)	0.2	(146.8)
 Net investment income	 6.3%	 \$ 3,994.3	 6.2%	 \$ 3,966.5

The following tables present the contributors to net realized capital gains and losses for our invested assets for the years ended December 31, 2008 and 2007.

For the year ended December 31, 2008			
Impairments and credit losses	Other gains (losses)	Hedging adjustments	Net realized capital gains (losses)

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	(in millions)							
Fixed maturity securities (1)	\$	(411.0)	\$	23.1	\$	496.3	\$	108.4
Fixed maturity securities, trading				(61.7)				(61.7)
Equity securities (2)		(46.2)		1.6				(44.6)
Equity securities, trading				(65.7)				(65.7)
Mortgage loans on real estate (3)		(44.8)						(44.8)
Derivatives (4)						(645.1)		(645.1)
Other (5)		(7.3)		(46.0)		112.7		59.4
Total	\$	(509.3)	\$	(148.7)	\$	(36.1)	\$	(694.1)

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(1)

Impairments include \$421.6 million of credit impairment write-downs and \$23.1 million in realized credit recoveries on the sale of previously impaired assets. Credit losses include \$13.7 million in realized losses related to credit triggered sales.

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- (2) Impairments include \$55.3 million of credit impairment write-downs and \$9.1 million in realized credit recoveries on the sale of previously impaired assets.
- (3) Impairments include \$27.8 million in realized losses due to the foreclosure of commercial mortgage loans and a \$16.5 million increase in the commercial mortgage loan valuation allowance.
- (4) Derivatives include \$526.8 million of net losses related to mark to market adjustments on derivatives used in fair value hedges of fixed maturity securities and \$156.7 million of net losses related to mark to market adjustments on derivatives used in fair value hedges of liabilities. The remainder of the net loss resulted primarily from mark to market adjustments on derivatives not designated as hedging instruments, with the largest components being \$121.0 million of net losses on credit default swaps, \$56.1 million of net gains on interest rate swaps, \$115.5 million of net gains on index options and the remainder relating to net gains from other risk management activities.
- (5) Impairments include \$7.3 million in realized losses on the investment in a money market mutual fund. Other gains (losses) primarily include net losses related to mark to market adjustments on certain seed money investments. Hedging adjustments primarily include net gains on certain liabilities in fair value hedging relationships.

	For the year ended December 31, 2007			
	Impairments and credit losses	Other gains (losses)	Hedging adjustments	Net realized capital gains (losses)
	<i>(in millions)</i>			
Fixed maturity securities (1)	\$ (262.8)	\$ 17.1	\$ 151.8	\$ (93.9)
Fixed maturity securities, trading		1.7		1.7
Equity securities (2)	(51.3)	5.0		(46.3)
Equity securities, trading		23.0		23.0
Mortgage loans on real estate (3)	(7.1)			(7.1)
Derivatives (4)			(228.5)	(228.5)
Other (5)		34.6	(12.3)	22.3
Total	\$ (321.2)	\$ 81.4	\$ (89.0)	\$ (328.8)

- (1) Impairments include \$215.7 million of credit impairment write-downs and \$8.4 million in realized credit recoveries on the sale of previously impaired assets. Certain fixed maturity securities moved into a loss position during the second quarter of 2007, and we determined that we did not have the ability and intent to hold these securities. As a result, we recognized impairment losses on these securities of \$24.5 million, net of recoveries on the subsequent sale, primarily due to a change in interest rates. Credit losses include \$32.3 million in realized losses and \$2.0 million in realized gains related to credit triggered sales.
- (2) Impairments include \$52.6 million of credit impairment write-downs and \$1.3 million in realized credit recoveries on the sale of previously impaired assets.
- (3) Impairments include \$2.7 million in realized gains that resulted from the sale of a commercial mortgage loan for which we had credit concerns and a \$9.8 million increase in the commercial mortgage loan valuation allowance.
- (4) Derivatives include \$153.5 million of net losses related to mark to market adjustments on derivatives used in fair value hedges of fixed maturity securities and \$39.4 million of net gains related to mark to market adjustment on derivatives used in fair value hedges of liabilities. The remainder of the net loss resulted primarily from mark to market adjustments on derivatives not designated as hedging instruments, with the largest component being \$81.1 million of net losses on credit default swaps and the remainder relating to net losses from other risk management activities.

(5)

Other gains (losses) include a \$24.6 million realized gain on the sale of stock of an equity method investment. Hedging adjustments primarily include net losses on certain liabilities in fair value hedging relationships.

#### **U.S. Investment Operations**

Of our invested assets, \$55.8 billion were held by our U.S. operations as of December 31, 2008. Our U.S. invested assets are managed primarily by Principal Global Investors. Our primary investment objective is to maximize after-tax returns consistent with acceptable risk parameters. We seek to protect policyholders' benefits by optimizing the risk/return relationship on an ongoing basis, through asset/liability matching, reducing the credit risk, avoiding high levels of investments that may be redeemed by the issuer, maintaining sufficiently liquid investments and avoiding undue asset concentrations through diversification. We are exposed to three primary sources of investment risk:

credit risk, relating to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest;



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interest rate risk, relating to the market price and/or cash flow variability associated with changes in market yield curves and

equity risk, relating to adverse fluctuations in a particular common stock.

Our ability to manage credit risk is essential to our business and our profitability. We devote considerable resources to the credit analysis of each new investment. We manage credit risk through industry, issuer and asset class diversification. Our Investment Committee, appointed by our Board of Directors, is responsible for establishing all investment policies and approving or authorizing all investments, except the Executive Committee of the Board must approve any investment transaction exceeding \$500.0 million. As of December 31, 2008, there are ten members on the Investment Committee, two of whom are members of our Board of Directors. The remaining members are senior management members representing various areas of our company.

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

Our Fixed Income Securities Committee, consisting of fixed income securities senior management members, approves the credit rating for the fixed maturity securities we purchase. Teams of security analysts, organized by industry, focus either on the public or private markets and analyze and monitor these investments. In addition, we have teams who specialize in residential mortgage-backed securities, commercial mortgage-backed securities ("CMBS"), asset-backed securities ("ABS") and public below investment grade securities. We establish a credit reviewed list of approved public issuers to provide an efficient way for our portfolio managers to purchase liquid bonds for which credit review has already been completed. Issuers remain on the list for one year unless removed by our analysts. Our analysts monitor issuers on the list on a continuous basis with a formal review documented annually or more frequently if material events affect the issuer. The analysis includes both fundamental and technical factors. The fundamental analysis encompasses both quantitative and qualitative analysis of the issuer.

The qualitative analysis includes an assessment of both accounting and management aggressiveness of the issuer. In addition, technical indicators such as stock price volatility and credit default swap levels are monitored.

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

material declines in the issuer's revenues or margins;

significant management or organizational changes;

significant uncertainty regarding the issuer's industry;

debt service coverage or cash flow ratios that fall below industry-specific thresholds;

violation of financial covenants and

other business factors that relate to the issuer.

A dedicated risk management team is responsible for centralized monitoring of the commercial mortgage loan portfolio. We apply a variety of strategies to minimize credit risk in our commercial mortgage loan portfolio. When considering the origination of new commercial mortgage loans, we review the cash flow fundamentals of the property, make a physical assessment of the underlying security, conduct a comprehensive market analysis and compare against industry lending practices. We use a proprietary risk rating model to evaluate all new and a majority of existing loans within the portfolio. The proprietary risk model is designed to stress projected cash flows under simulated economic and market downturns. Our lending guidelines are designed to encourage 75% or less loan-to-value ratios and a debt service coverage ratio of at least 1.2 times. We analyze investments outside of these guidelines based on cash flow quality, tenancy and other factors. The weighted average loan-to-value ratio at origination for brick and mortar commercial mortgages in our portfolio was 59% and 65% as of December 31, 2008 and

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2007, respectively. The debt service coverage ratio at loan inception was 1.7 times as of both December 31, 2008 and 2007.

We have limited exposure to equity risk in our common stock portfolio.

Our investment decisions and objectives are a function of the underlying risks and product profiles of each primary business operation. In addition, we diversify our product portfolio offerings to include products that contain features that will protect us against fluctuations in interest rates. Those features include adjustable crediting rates, policy surrender charges and market value adjustments on liquidations. For further information on our management of interest rate risk, see Item 7A. "Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk."

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## Overall Composition of U.S. Invested Assets

U.S. invested assets as of December 31, 2008, were predominantly high quality and broadly diversified across asset class, individual credit, industry and geographic location. Asset allocation is determined based on cash flow and the risk/return requirements of our products. As shown in the following table, the major categories of U.S. invested assets are fixed maturity securities and commercial mortgage loans. The remainder is invested in residential mortgage loans, real estate, equity securities and other assets. In addition, policy loans are included in our invested assets. The following discussion analyzes the composition of U.S. invested assets, but excludes invested assets of the separate accounts.

	December 31, 2008		December 31, 2007	
	Carrying amount	% of total	Carrying amount	% of total
(\$ in millions)				
Fixed maturity securities:				
Public	\$ 26,652.5	48%	\$ 29,127.7	48%
Private	12,173.9	22	15,421.0	26
Equity securities	359.9	1	533.5	1
Mortgage loans:				
Commercial	11,279.3	20	10,763.5	18
Residential	1,354.4	2	1,337.5	2
Real estate held for sale	135.4		82.4	
Real estate held for investment	779.8	1	777.2	1
Policy loans	881.4	2	853.7	2
Other investments	2,162.4	4	1,391.4	2
 Total invested assets	 55,779.0	 100%	 60,287.9	 100%
 Cash and cash equivalents	 2,537.0		 1,261.5	
 Total invested assets and cash	 \$ 58,316.0		 \$ 61,549.4	

## Fixed Maturity Securities

Fixed maturity securities consist of short-term investments, publicly traded debt securities, privately placed debt securities and redeemable preferred stock. Included in the privately placed category as of December 31, 2008 and 2007, were \$6.1 billion and \$8.4 billion, respectively, of securities eligible for resale to qualified institutional buyers under Rule 144A under the Securities Act of 1933.

Fixed maturity securities were diversified by category of issuer as of December 31, 2008 and 2007, as shown in the following table:

	December 31, 2008		December 31, 2007	
	Carrying amount	% of total	Carrying amount	% of total
(\$ in millions)				
U.S. Government and agencies	\$ 595.2	1%	\$ 672.3	2%
States and political subdivisions	2,176.7	6	2,071.5	5
Non-U.S. governments	478.5	1	453.9	1
Corporate public	17,224.9	44	19,517.9	44
Corporate private	10,365.4	27	12,170.4	27
Residential pass-through securities	2,187.9	6	1,496.1	3
Commercial mortgage-backed securities	3,607.1	9	4,665.6	10
Residential collateralized mortgage obligations	768.6	2	936.9	2
Asset-backed securities	1,422.1	4	2,564.1	6
 Total fixed maturity securities	 \$ 38,826.4	 100%	 44,548.7	 100%

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

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CMBS provide varying levels of credit protection, diversification and reduced event risk depending on the securities owned and composition of the loan pool. CMBS are predominantly comprised of large pool securitizations that are diverse by property type, borrower and geographic dispersion. The risks to any CMBS deal are determined by the credit quality of the underlying loans and how those loans perform over time. Another key risk is the vintage of the underlying loans and the state of the markets during a particular vintage. In the CMBS market, there is a material difference in the

outlook for the performance of loans originated in 2005 and earlier relative to loans originated in 2006 through 2008. For loans originated prior to 2006, underwriting assumptions were more conservative regarding required debt service coverage and loan-to-value ratios. For the 2006 and 2007 vintages, real estate values peaked and the underwriting expectations were that income would continue to increase which make those loan values more sensitive to market declines.

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

The international exposure held in our U.S. operation's fixed maturity securities portfolio totaled \$8,178.3 million, or 21%, and \$10,046.5 million, or 23%, of total fixed maturity securities, as of December 31, 2008 and 2007, respectively. It is comprised of corporate and foreign government fixed maturity securities. The following table presents our international exposure for our U.S. operation's fixed maturity securities portfolio for the periods indicated.

	December 31, 2008	December 31, 2007
	<i>(in millions)</i>	
European Union	\$ 2,432.9	\$ 2,843.1
United Kingdom	2,049.5	2,641.7
Asia	973.3	1,059.0
Australia	743.5	954.1
South America	500.8	594.6
Mexico	264.9	340.3
Japan	50.8	59.4
Other countries (1)	1,162.6	1,554.3
<b>Total</b>	<b>\$ 8,178.3</b>	<b>\$ 10,046.5</b>

(1) Includes exposure from 24 countries as of both December 31, 2008 and December 31, 2007.

All international fixed maturity securities held by our U.S. operations are either denominated in U.S. dollars or have been swapped into U.S. dollar equivalents. Our international investments are analyzed internally by country and industry credit investment professionals. We control concentrations using issuer and country level exposure benchmarks, which are based on the credit quality of the issuer and the country. Our investment policy limits total international fixed maturity securities investments to 20% of total statutory general account assets with a 4% limit in emerging markets. Exposure to Canada is not included in our international exposure. As of December 31, 2008 and 2007, our investments in Canada totaled \$1,402.2 million and \$1,576.4 million, respectively.

**Fixed Maturity Securities Credit Concentrations.** One aspect of managing credit risk is through industry issuer and asset class diversification. Our credit concentrations are managed to established limits. Our top ten exposures were rated an "A-" equivalent or better by the rating agencies and no individual non-government issuer represented more than 1% of U.S. invested assets as of December 31, 2008. The exposure that had been attributed to monoline bond and mortgage insurers from investments we own that are guaranteed by them is no longer included in the evaluation of our top ten

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exposures. We are no longer relying on said guarantors and are directly evaluating exposure to these investments. The following table presents our top ten exposures as of December 31, 2008.

	December 31, 2008
	Amortized cost
	(in millions)
Bank of America Corp.	\$ 385.9
JP Morgan Chase & Co. (1)	316.5
Wells Fargo & Co. (1)	261.9
General Electric Co.	242.6
AT&T Inc.	213.2
American International Group, Inc.	191.9
Credit Suisse Group AG	157.7
Deutsche Bank AG (1)	155.1
Berkshire Hathaway Inc.	152.8
Royal Bank of Scotland Group PLC	146.8
 Total top ten exposures	 \$ 2,224.4

(1)

Includes actual counterparty exposure.

We have exposure to monoline bond and mortgage insurers with an amortized cost of \$753.0 million and a carrying amount of \$734.0 million as of December 31, 2008. The \$753.0 million includes wrapped guarantees on \$704.7 million of underlying municipal bonds, corporate credit or ABS. Our direct exposure to these insurers was \$48.3 million. Of the \$704.7 million in wrapped guarantees, 47% was municipal bonds, of which 99% was investment grade; 37% was investment grade bank perpetual preferred securities; 10% was ABS backed by sub-prime first lien mortgages, of which 53% was investment grade; and 6% was corporate fixed maturities, of which 91% was investment grade.

On September 7, 2008, the United States Treasury announced that FNMA and FHLMC had been placed into conservatorship. As of December 31, 2008, our direct exposure consisted of fixed maturity securities with an amortized cost of \$578.0 million and a carrying value of \$623.2 million and equity securities with a cost of \$0.6 million and carrying value of \$0.1 million. For the year ended December 31, 2008, we recorded a \$6.0 million realized capital loss on the equity securities. We had sold \$20.0 million notional of credit default swap ("CDS") protection referencing FNMA and FHLMC debt. This CDS was terminated during the fourth quarter 2008 and a realized capital loss of \$1.3 million was recorded.

On September 14, 2008, Lehman Brothers Holdings Inc. ("Lehman Brothers") declared bankruptcy. For the year ended December 31, 2008, we recorded a \$112.6 million realized capital loss due to impairment of fixed maturity and equity securities. Our exposure to Lehman Brothers includes fixed maturity securities with both an amortized cost and carrying value of \$6.7 million as of December 31, 2008. We had purchased CDS protection on Lehman Brothers with a notional of \$15.0 million. This CDS was terminated during the fourth quarter of 2008 and a realized capital gain of \$13.2 million was recorded.

On September 16, 2008, the United States government took control of AIG, which is one of our top ten exposures. As of December 31, 2008, our exposure to AIG included fixed maturity securities and equity securities with a cost of \$206.9 million and a carrying value of \$132.8 million. The fixed maturity securities include \$59.4 million of amortized cost and \$49.9 million of carrying value of International Lease Finance Corp, \$107.5 million of amortized cost and \$65.3 million of carrying value of American General Finance Corp, \$6.7 million of amortized cost and \$2.4 million of carrying value of AIG Life Holdings (US), Inc., \$15.0 million of amortized cost and \$10.2 million of carrying value of 21<sup>st</sup> Century Insurance Group, and \$3.3 million of amortized cost and \$3.6 million of carrying value of American International Specialty Lines Insurance Company. The equity securities consist of \$15.0 million of cost and \$1.4 million of carrying value of International Lease Finance Corp. We have credit default swap protection on International Lease Finance Corp with a notional of \$15.0 million and a fair value of \$3.3 million recorded as a realized capital gain.

On September 25, 2008, the United States Office of Thrift Supervision seized Washington Mutual Savings Bank ("WMSB") from Washington Mutual, Inc. ("Washington Mutual"), placed WMSB into receivership and sold WMSB to JPMorgan Chase. On September 26,

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2008, Washington Mutual declared bankruptcy. As of September 30, 2008, our remaining exposure to Washington Mutual fixed maturity securities was written off. For the year ended December 31, 2008, we recorded a \$69.7 million realized capital loss through the sales of fixed maturity securities and the final impairment of remaining securities.

***Fixed Maturity Securities Credit Quality.*** Valuation techniques for the fixed maturity securities portfolio vary by security type and the availability of market data. Pricing models and their underlying assumptions impact the amount and timing of unrealized gains and losses recognized, and the use of different pricing models or assumptions could produce different financial results. Valuations are generally obtained from third-party pricing services and broker quotes when

available. For corporate bonds where quoted market prices are not available, a matrix pricing valuation approach is used. Securities are grouped into pricing categories that vary by sector, rating and average life. Each pricing category is assigned a risk spread based on studies of observable public market data or market clearing data from the investment professionals assigned to specific security classes. The expected cash flows of the security are then discounted back at the current Treasury curve plus the appropriate risk spread. Although the matrix valuation approach provides a fair valuation of each pricing category, the valuation of an individual security within each pricing category may actually be impacted by company specific factors. Certain market events that could impact the valuation of securities include issuer credit ratings, business climate, management changes, litigation and government actions, among others. Internal models specific to the asset class may also be used. Prices are then reviewed by pricing analysts for reasonableness based on asset class given observable market data. In addition, investment analysts who are familiar with specific securities review prices for reasonableness through direct interaction with external sources, recent trade activity or internal models. Monthly, all bonds placed on the "watch list" are analyzed by investment analysts or analysts that focus on troubled securities ("Workout Group"). This group then meets with the Chief Investment Officer and the Portfolio Managers to determine reasonableness of prices. The valuation of impaired bonds for which there is no quoted price is typically based on the present value of the future cash flows expected to be received. Although we believe these values reasonably reflect the fair value of those securities, the key assumptions about risk premiums, performance of underlying collateral (if any) and other market factors involve qualitative inputs.

The Securities Valuation Office ("SVO") of the NAIC evaluates the bond investments of insurers for regulatory reporting purposes and assigns securities to one of six investment categories. The NAIC designations closely mirror the NRSROs' credit ratings for marketable bonds. NAIC designations 1 and 2 include bonds considered investment grade by such rating organizations. Bonds are considered investment grade when rated "Baa3" or higher by Moody's, or "BBB-" or higher by Standard & Poor's. NAIC designations 3 through 6 are referred to as below investment grade. Bonds are considered below investment grade when rated "Ba1" or lower by Moody's, or "BB+" or lower by Standard & Poor's. As of December 31, 2008, the percentage, based on fair value, of total publicly traded and privately placed fixed maturity securities that were investment grade with an NAIC designation 1 or 2 was 95%.

The following table presents our total fixed maturity securities by NAIC designation and the equivalent ratings of the NRSROs as of December 31, 2008 and 2007, as well as the percentage, based on fair value, that each designation comprises:

NAIC rating	Rating agency equivalent	December 31, 2008			December 31, 2007		
		Amortized cost	Carrying amount	% of total carrying amount	Amortized cost	Carrying amount	% of total carrying amount
		(\$ in millions)					
1	Aaa/Aa/A	\$ 25,981.0	\$ 22,116.9	57%	\$ 25,635.0	\$ 25,644.1	57%
2	Baa	17,669.2	14,675.2	38	16,661.8	16,742.0	38
3	Ba	2,469.8	1,760.6	5	1,904.7	1,872.0	4
4	B	254.2	163.9		179.0	179.4	1
5	Caa and lower	109.7	62.3		103.1	99.3	
6	In or near default	71.2	47.5		12.0	11.9	
	Total fixed maturity securities	\$ 46,555.1	\$ 38,826.4	100%	\$ 44,495.6	\$ 44,548.7	100%

Fixed maturity securities include 16 securities with an amortized cost of \$135.1 million, gross gains of \$2.3 million, gross losses of \$7.4 million and a carrying amount of \$130.0 million as of December 31, 2008, that are still pending a review and assignment of a rating by the SVO. Due to the timing of when fixed maturity securities are purchased, legal documents are filed and the review by the SVO is completed, there will always be securities in our portfolio that are unrated over a reporting period. In these instances, an equivalent rating is assigned based on our fixed income analyst's assessment.

**Commercial Mortgage-Backed Securities and Home Equity Asset-Backed Securities Portfolios.** As of December 31, 2008, based on amortized cost, 89% of our CMBS portfolio had ratings of A or higher and 60% was issued in 2005 or before and 78% of our ABS home equity portfolio had ratings of A or higher and 85% was issued in 2005 or before.



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The following table presents credit quality and year of issuance ("vintage") for our CMBS:

	December 31, 2008		December 31, 2007	
	Amortized cost	Carrying amount	Amortized cost	Carrying amount
<i>(in millions)</i>				
<b>Lowest agency rating</b>				
AAA	\$ 3,558.3	\$ 2,757.0	\$ 2,818.8	\$ 2,829.6
AA	812.7	373.4	645.3	631.3
A	673.0	270.8	636.4	601.4
BBB	555.3	179.7	569.8	504.8
BB and below	86.0	26.2	84.1	98.5
<b>Total by lowest agency rating</b>	<b>\$ 5,685.3</b>	<b>\$ 3,607.1</b>	<b>\$ 4,754.4</b>	<b>\$ 4,665.6</b>
<b>Vintage</b>				
2003 and prior	\$ 1,888.6	\$ 1,587.2	\$ 2,092.9	\$ 2,174.9
2004	586.3	393.5	545.6	523.4
2005	913.6	547.9	716.2	683.4
2006 (1)	563.4	282.8	428.2	389.7
2007 (1)	1,642.3	750.4	971.5	894.2
2008	91.1	45.3		
<b>Total by vintage</b>	<b>\$ 5,685.3</b>	<b>\$ 3,607.1</b>	<b>\$ 4,754.4</b>	<b>\$ 4,665.6</b>

(1)

As of December 31, 2008, 56% of the 2006 vintage are rated AAA and 12% are rated AA, and 63% of the 2007 vintage are rated AAA and 18% are rated AA.

The following table presents our exposure to ABS home equity portfolio supported by subprime first lien mortgages by credit quality and vintage:

	December 31, 2008		December 31, 2007	
	Amortized cost	Carrying amount	Amortized cost	Carrying amount
<i>(in millions)</i>				
<b>Lowest agency rating</b>				
AAA	\$ 281.8	\$ 201.5	\$ 454.4	\$ 434.1
AA	94.0	56.0	105.1	90.9
A	47.6	28.2	31.4	27.4
BBB	89.3	43.8	8.1	4.6
BB and below	32.4	17.2		
<b>Total by lowest agency rating</b>	<b>\$ 545.1</b>	<b>\$ 346.7</b>	<b>\$ 599.0</b>	<b>\$ 557.0</b>
<b>Vintage</b>				
2003 and prior	\$ 270.2	\$ 197.9	\$ 307.6	\$ 290.2
2004	91.1	53.7	104.3	100.2
2005	101.8	54.9	107.6	97.6
2006	18.8	10.3	16.3	15.7
2007	63.2	29.9	63.2	53.3
<b>Total by vintage</b>	<b>\$ 545.1</b>	<b>\$ 346.7</b>	<b>\$ 599.0</b>	<b>\$ 557.0</b>

**Fixed Maturity Securities Watch List.** We monitor any decline in the credit quality of fixed maturity securities through the designation of "problem securities," "potential problem securities" and "restructured securities". We define problem securities in our fixed maturity portfolio as securities: (i) as to which principal and/or interest payments are in default or where default is perceived to be imminent in the near term, or

(ii) issued by a company that went into bankruptcy subsequent to the acquisition of such securities. We define potential problem securities in our fixed maturity portfolio as securities included on an internal "watch list" for which management has concerns as to the ability of the issuer to comply with the present debt payment terms and which may result in the security becoming a problem or being restructured. The decision whether to classify a performing fixed maturity security as a potential problem involves significant subjective judgments by our management as to the likely future industry conditions and developments with respect to the issuer. We define restructured securities in our fixed maturity portfolio as securities where a concession has been granted to the borrower related to the borrower's financial difficulties that would not have otherwise been considered. We determine that restructures should occur in those instances where greater economic value will be realized under the new terms than through liquidation or other disposition and may involve a change in contractual cash flows. If, at the time of restructure,

the present value of the new future cash flows is less than the current cost of the asset being restructured, a realized capital loss is recorded in net income and a new cost basis is established.

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

	December 31, 2008	December 31, 2007
	(\$ in millions)	
Total fixed maturity securities (public and private)	\$ 38,826.4	\$ 44,548.7
Problem fixed maturity securities (1)	\$ 83.3	\$ 13.1
Potential problem fixed maturity securities	165.7	29.2
Restructured fixed maturity securities	3.1	5.9
Total problem, potential problem and restructured fixed maturity securities	\$ 252.1	\$ 48.2
Total problem, potential problem and restructured fixed maturity securities as a percent of total fixed maturity securities	.65%	.11%

- (1) The problem fixed maturity securities carrying amount is net of other than temporary impairment losses recorded as net realized capital losses in the consolidated statements of operations.

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

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

We consider relevant facts and circumstances in evaluating whether a credit or interest-rate related impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) our ability and intent to hold the security for a period of time that allows for the recovery in value which, in some cases, may extend to maturity. To the extent we determine that a security is deemed to be other than temporarily impaired, the difference between amortized cost and fair value would be charged to net income.

There are a number of significant risks and uncertainties inherent in the process of monitoring credit impairments and determining if an impairment is other than temporary. These risks and uncertainties include: (1) the risk that our assessment of an issuer's ability to meet all of its contractual obligations will change based on changes in the credit characteristics of that issuer, (2) the risk that the economic outlook will be worse than expected or have more of an impact on the issuer than anticipated, (3) the risk that our investment professionals are making decisions based on fraudulent or misstated information in the financial statements provided by issuers and (4) the risk that new information obtained by us or changes in other facts and circumstances lead us to change our intent to hold the security to maturity or until it recovers in value. Any of these situations could result in a charge to net income in a future period.

The net realized loss relating to other than temporary credit impairments of fixed maturity securities was \$397.0 million and \$207.3 million for the year ended December 31, 2008 and 2007, respectively.

For the year ended December 31, 2008 and 2007, we realized \$16.1 million and \$34.6 million of gross realized losses upon disposal of bonds excluding hedging adjustments. Included in the 2008 loss is \$13.7 million related to sales of sixteen names that experienced credit

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deterioration during the period. Included in the 2007 loss is \$32.3 million related to sales of forty-two credit impaired and credit related names. We generally intend to hold securities in unrealized loss positions until they mature or recover. However, we do sell bonds under certain circumstances, such as when we have evidence of a significant deterioration in the issuer's creditworthiness, when a change in regulatory requirements modifies what constitutes a permissible investment or the maximum level of investments held or when there is an increase in capital requirements or a change in risk weights of debt securities. Sales generate both gains and losses.

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**Fixed Maturity Securities Available-for-Sale**

The following tables present our fixed maturity securities available-for-sale by industry category and the associated gross unrealized gains and losses as of December 31, 2008 and 2007.

		Amortized cost	December 31, 2008		Carrying amount
			Gross unrealized gains	Gross unrealized losses	
(in millions)					
Finance	Banking	\$ 4,248.7	\$ 14.9	\$ 1,095.1	\$ 3,168.5
Finance	Brokerage	785.4	0.9	128.5	657.8
Finance	Finance Companies	418.6	0.1	84.7	334.0
Finance	Financial Other	753.3	6.8	104.6	655.5
Finance	Insurance	2,885.8	38.1	706.6	2,217.3
Finance	REITS	1,412.5		430.6	981.9
Industrial	Basic Industry	2,030.0	10.6	303.8	1,736.8
Industrial	Capital Goods	2,322.3	15.1	316.8	2,020.6
Industrial	Communications	2,943.7	32.3	297.0	2,679.0
Industrial	Consumer Cyclical	2,023.8	18.7	338.7	1,703.8
Industrial	Consumer Non-Cyclical	3,184.7	31.2	298.5	2,917.4
Industrial	Energy	1,958.0	9.6	224.5	1,743.1
Industrial	Other	952.8	2.4	117.6	837.6
Industrial	Technology	876.7	2.2	115.3	763.6
Industrial	Transportation	992.2	10.3	124.5	878.0
Utility	Electric	2,473.4	22.8	199.2	2,297.0
Utility	Natural Gas	1,142.0	4.9	110.7	1,036.2
Utility	Other	156.7	2.3	14.3	144.7
Government guaranteed		799.5	75.0	57.0	817.5
Total corporate securities		32,360.1	298.2	5,068.0	27,590.3
Residential pass-through securities		1,627.5	50.5	0.5	1,677.5
Commercial mortgage-backed securities		5,682.7	3.7	2,081.9	3,604.5
Residential collateralized mortgage obligations (1)		950.8	6.4	188.6	768.6
Asset-backed securities	Home equity (2)	545.1	0.1	198.5	346.7
Asset-backed securities	All other	816.1	16.8	137.2	695.7
Collateralized debt obligations	Credit	202.8		123.6	79.2
Collateralized debt obligations	CMBS	302.2		173.3	128.9
Collateralized debt obligations	Loans	91.4		54.4	37.0
Collateralized debt obligations	ABS (3)	100.0	0.2	53.5	46.7
Total mortgage-backed and other asset-backed securities		10,318.6	77.7	3,011.5	7,384.8
U.S. Government and agencies		548.4	46.9	0.1	595.2
States and political subdivisions		2,113.8	32.6	120.9	2,025.5
Non-U.S. governments		462.1	31.5	15.1	478.5
Total fixed maturity securities, available-for-sale		\$ 45,803.0	\$ 486.9	\$ 8,215.6	\$ 38,074.3

(1) Includes exposure to Alt-a mortgage loans with an amortized cost of \$67.3 million, gross unrealized losses of \$17.3 million and a carrying amount of \$50.0 million. The Alt-a portfolio has a weighted average rating of AA and 66% are 2005 and prior vintages.

(2) This exposure is all related to sub-prime mortgage loans.

(3)

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Includes exposure to sub-prime mortgage loans with an amortized cost of \$66.4 million, gross unrealized gains of \$0.1 million, gross unrealized losses of \$46.6 million and a carrying amount of \$19.9 million.

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			December 31, 2007		
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Carrying amount
		(in millions)			
Finance	Banking	\$ 4,228.8	\$ 46.0	\$ 176.7	\$ 4,098.1
Finance	Brokerage	1,041.2	9.9	25.7	1,025.4
Finance	Finance Companies	572.0	5.4	46.4	531.0
Finance	Financial Other	685.1	43.3	7.6	720.8
Finance	Insurance	2,954.6	90.8	65.8	2,979.6
Finance	REITS	1,424.6	7.4	57.3	1,374.7
Industrial	Basic Industry	1,814.4	52.5	35.9	1,831.0
Industrial	Capital Goods	2,176.2	71.9	23.7	2,224.4
Industrial	Communications	3,033.4	142.4	31.9	3,143.9
Industrial	Consumer Cyclical	1,941.7	34.7	53.9	1,922.5
Industrial	Consumer Non-Cyclical	2,744.3	93.2	35.2	2,802.3
Industrial	Energy	1,866.4	96.9	11.3	1,952.0
Industrial	Other	1,046.4	14.6	13.9	1,047.1
Industrial	Technology	611.8	8.1	7.7	612.2
Industrial	Transportation	1,086.9	44.3	24.4	1,106.8
Utility	Electric	2,168.1	79.6	18.4	2,229.3
Utility	Natural Gas	1,049.8	47.7	10.1	1,087.4
Utility	Other	87.0	5.6	3.7	88.9
Government guaranteed		819.1	68.2	6.4	880.9
Total corporate securities		31,351.8	962.5	656.0	31,658.3
Residential pass-through securities					
		1,481.5	23.6	9.0	1,496.1
Commercial mortgage-backed securities		4,754.4	107.4	196.2	4,665.6
Residential collateralized mortgage obligations (1)		947.7	3.3	14.1	936.9
Asset-backed securities	Home equity (2)	599.0	0.1	42.1	557.0
Asset-backed securities	All other	892.6	19.1	8.3	903.4
Collateralized debt obligations	Credit	735.4	0.1	123.6	611.9
Collateralized debt obligations	CMBS	332.7	1.4	71.6	262.5
Collateralized debt obligations	Loans	88.8		5.7	83.1
Collateralized debt obligations	ABS (3)	94.1		30.1	64.0
Total mortgage-backed and other asset-backed securities		9,926.2	155.0	500.7	9,580.5
U.S. Government and agencies		628.5	29.0	0.1	657.4
States and political subdivisions		1,867.6	39.1	10.2	1,896.5
Non-U.S. governments		419.4	35.7	1.2	453.9
Total fixed maturity securities, available-for-sale		\$44,193.5	\$ 1,221.3	\$ 1,168.2	\$44,246.6

(1)

Includes exposure to Alt-a mortgage loans with an amortized cost of \$78.7 million, gross unrealized gains of \$0.4 million, gross unrealized losses of \$4.1 million and a carrying amount of \$75.0 million. All of these securities are rated AAA and 62% are 2005 and prior vintages.

(2)

This exposure is all related to sub-prime mortgage loans.

(3)

Includes exposure to sub-prime mortgage loans with an amortized cost of \$79.1 million, gross unrealized losses of \$28.8 million and a carrying amount of \$50.3 million.

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Of the \$8,215.6 million in gross unrealized losses as of December 31, 2008, there were \$46.3 million in losses attributed to securities scheduled to mature in one year or less, \$1,191.7 million attributed to securities scheduled to mature between one to five years, \$1,826.9 million attributed to securities scheduled to mature between five to ten years, \$2,139.2 million attributed to securities scheduled to mature after ten years and \$3,011.5 million related to mortgage-backed and other ABS that are not classified by maturity year.

The credit disruption in the market that began in the last half of 2007 from concerns in the sub-prime markets, and continued into 2008 with concerns in the leveraged finance markets has led to reduced liquidity and wider credit spreads. These credit concerns led to a widespread forced selling into a very thinly traded market which further strained market liquidity. This market disruption lowered valuations and, as a result, we have seen an increase in unrealized losses in our securities portfolio. The losses were more pronounced in the Finance sectors and in structured products such as collateralized debt obligations, ABS and CMBS. The decline in value in large part reflects the illiquid markets. Future changes in the fair value of these securities will be dependent on the return of market liquidity and changes in general



market conditions, including interest rates and credit spread movements. Due to the issuers' continued satisfaction of the securities' obligations in accordance with their contractual terms, the expectation that they will continue to do so given the evaluation of the fundamentals of the issuers' financial condition and other objective evidence and management's intent and ability to hold these securities to recovery, we concluded that the prices of the securities in our securities portfolio were temporarily depressed.

As discussed previously, a significant contributor to the low investment valuations and the resulting unrealized losses is market illiquidity. We have estimated the effect of the market illiquidity on significant portions of our investment portfolio by measuring the difference between valuations provided by the cash bond market and those provided by the synthetic market for a portion of the corporate bond and CMBS securities held in our investment portfolio. In the current market environment the synthetic market has more liquidity than the cash bond market.

**Corporate Bonds.** The population for the corporate bond analysis included corporate debentures we own from the Finance, Industrial and Utility sectors and excluded redeemable preferred stock, government guaranteed securities, securities with a structured component, and other securities without the necessary relevant data. This population had an amortized cost of \$30,269.8 million, carrying value of \$25,689.4 million, and a net unrealized loss of \$4,580.4 million as of December 31, 2008. The market illiquidity was estimated using CDS spreads. For 62% of the population we used name specific CDS spreads and for the remainder we used relevant sector specific CDS spreads. We estimated that the decline in value of this population attributable to market illiquidity was \$3,372.5 million.

**Commercial Mortgage-Backed Securities.** The population for our CMBS analysis included principal and interest bonds but excluded interest only bonds as of December 31, 2008. This population had an amortized cost of \$4,585.7 million, carrying value of \$2,806.0 million, and a net unrealized loss of \$1,779.7 million. The market illiquidity was estimated using the commercial mortgage-backed security index (CMBX) spreads for various vintage and rating buckets. We estimated that the decline in value of this population attributable to market illiquidity was \$814.6 million.

**Fixed Maturity Available-for-Sale Securities Unrealized Losses.** We believe that our long-term fixed maturity securities portfolio is well diversified among industry types and between publicly traded and privately placed securities. Each year, we direct the majority of our net cash inflows into investment grade fixed maturity securities. The net cash inflows into investment grade fixed maturity securities are less than prior years due to us investing in more liquid investments. Our current policy is to limit the percentage of cash flow invested in below investment grade assets to 10% of cash flow. As of December 31, 2008, we had invested 4.2% of new cash flow for the year in below investment grade assets. While the general account investment returns have improved due to the below investment grade asset class, we manage its growth strategically by limiting it to no more than 10% of the total fixed maturity securities portfolios.

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

The following table presents our fixed maturity securities available-for-sale by investment grade and below investment grade and the associated gross unrealized gains and losses for the time periods indicated.

	Amortized cost	December 31, 2008 Gross unrealized gains	December 31, 2008 Gross unrealized losses	Carrying amount	Amortized cost	December 31, 2007 Gross unrealized gains	December 31, 2007 Gross unrealized losses	Carrying amount
<i>(in millions)</i>								
Investment grade:								
Public	\$ 28,981.9	\$ 308.3	\$ 4,253.1	\$ 25,037.1	\$ 27,623.6	\$ 747.4	\$ 563.9	\$ 27,807.1
Private	13,916.2	175.9	3,089.2	11,002.9	14,371.1	415.7	509.9	14,276.9
Below investment grade:								
Public	1,319.4	1.6	385.5	935.5	1,117.2	27.3	63.7	1,080.8
Private	1,585.5	1.1	487.8	1,098.8	1,081.6	30.9	30.7	1,081.8
Total fixed maturity securities, available-for-sale	\$ 45,803.0	\$ 486.9	\$ 8,215.6	\$ 38,074.3	\$ 44,193.5	\$ 1,221.3	\$ 1,168.2	\$ 44,246.6

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The following tables present our investment grade fixed maturity securities available-for-sale and the associated gross unrealized losses by aging category for the time periods indicated.

	December 31, 2008					
	Public		Private		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 3,086.0	\$ 194.4	\$ 1,188.1	\$ 99.5	\$ 4,274.1	\$ 293.9
Greater than three to six months	4,213.7	467.9	1,673.6	236.4	5,887.3	704.3
Greater than six to nine months	3,014.0	620.7	1,566.6	290.6	4,580.6	911.3
Greater than nine to twelve months	2,321.0	743.0	1,259.7	460.1	3,580.7	1,203.1
Greater than twelve to twenty-four months	3,042.0	1,507.5	2,217.1	1,519.7	5,259.1	3,027.2
Greater than twenty-four to thirty-six months	1,045.2	296.1	312.5	217.1	1,357.7	513.2
Greater than thirty-six months	1,363.8	423.5	698.2	265.8	2,062.0	689.3
Total fixed maturity securities, available-for-sale	\$ 18,085.7	\$ 4,253.1	\$ 8,915.8	\$ 3,089.2	\$ 27,001.5	\$ 7,342.3

	December 31, 2007					
	Public		Private		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 2,829.6	\$ 69.3	\$ 1,585.5	\$ 38.6	\$ 4,415.1	\$ 107.9
Greater than three to six months	1,233.1	86.4	1,075.4	123.0	2,308.5	209.4
Greater than six to nine months	1,460.9	109.3	1,285.7	123.1	2,746.6	232.4
Greater than nine to twelve months	993.2	74.6	719.4	107.0	1,712.6	181.6
Greater than twelve to twenty-four months	1,511.2	98.4	614.7	47.8	2,125.9	146.2
Greater than twenty-four to thirty-six months	3,049.7	104.3	1,119.6	58.0	4,169.3	162.3
Greater than thirty-six months	607.9	21.6	364.2	12.4	972.1	34.0
Total fixed maturity securities, available-for-sale	\$ 11,685.6	\$ 563.9	\$ 6,764.5	\$ 509.9	\$ 18,450.1	\$ 1,073.8

The following tables present our below investment grade fixed maturity securities available-for-sale and the associated gross unrealized losses by aging category for the time periods indicated.

	December 31, 2008					
	Public		Private		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	\$ 133.1	\$ 56.5	\$ 114.6	\$ 32.1	\$ 247.7	\$ 88.6
Greater than three to six months	88.8	12.7	297.1	74.3	385.9	87.0
Greater than six to nine months	102.5	42.9	129.1	46.5	231.6	89.4
Greater than nine to twelve months	163.0	65.9	44.5	43.7	207.5	109.6
Greater than twelve to twenty-four months	242.0	151.7	351.8	239.5	593.8	391.2
Greater than twenty-four to thirty-six months	41.2	26.1	13.3	21.4	54.5	47.5
Greater than thirty-six months	100.3	29.7	100.9	30.3	201.2	60.0
	\$ 870.9	\$ 385.5	\$ 1,051.3	\$ 487.8	\$ 1,922.2	\$ 873.3

Total fixed maturity securities,  
available-for-sale

	December 31, 2007					
	Public Carrying amount	Gross unrealized losses	Private Carrying amount	Gross unrealized losses	Total Carrying amount	Gross unrealized losses
	<i>(in millions)</i>					
Three months or less	\$ 95.4	\$ 4.0	\$ 187.0	\$ 5.5	\$ 282.4	\$ 9.5
Greater than three to six months	62.8	2.6	115.6	5.4	178.4	8.0
Greater than six to nine months	123.2	22.7	98.6	3.1	221.8	25.8
Greater than nine to twelve months	91.5	11.3	17.3	0.7	108.8	12.0
Greater than twelve to twenty-four months	57.0	11.1	21.7	13.0	78.7	24.1
Greater than twenty-four to thirty-six months	138.3	11.4	72.9	2.1	211.2	13.5
Greater than thirty-six months	16.5	0.6	26.6	0.9	43.1	1.5
Total fixed maturity securities, available-for-sale	\$ 584.7	\$ 63.7	\$ 539.7	\$ 30.7	\$ 1,124.4	\$ 94.4

The following tables present the carrying amount and the gross unrealized losses on fixed maturity securities available-for-sale where the estimated fair value has declined and remained below amortized cost by 20% or more as the time periods indicate.

	December 31, 2008					
	Problem, potential problem, and restructured Carrying amount	Gross unrealized losses	All other fixed maturity securities Carrying amount	Gross unrealized losses	Total Carrying amount	Gross unrealized losses
	<i>(in millions)</i>					
Three months or less	\$ 53.7	\$ 70.2	\$ 6,433.5	\$ 3,133.6	\$ 6,487.2	\$ 3,203.8
Greater than three to six months	27.5	28.5	1,374.2	1,314.6	1,401.7	1,343.1
Greater than six to nine months	6.1	14.5	279.3	415.5	285.4	430.0
Greater than nine to twelve months	11.5	10.3	486.8	904.1	498.3	914.4
Greater than twelve months	3.5	6.5	111.3	435.2	114.8	441.7
Total fixed maturity securities, available-for-sale	\$ 102.3	\$ 130.0	\$ 8,685.1	\$ 6,203.0	\$ 8,787.4	\$ 6,333.0

	December 31, 2007					
	Problem, potential problem, and restructured Carrying amount	Gross unrealized losses	All other fixed maturity securities Carrying amount	Gross unrealized losses	Total Carrying amount	Gross unrealized losses
	<i>(in millions)</i>					
Three months or less	\$	\$	\$ 670.2	\$ 240.2	\$ 670.2	\$ 240.2
Greater than three to six months			110.7	80.9	110.7	80.9
Greater than six to nine months			0.5	0.3	0.5	0.3
Greater than nine to twelve months						
Greater than twelve months						
Total fixed maturity securities, available-for-sale	\$	\$	\$ 781.4	\$ 321.4	\$ 781.4	\$ 321.4

### Mortgage Loans

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Mortgage loans consist primarily of commercial mortgage loans on real estate. The carrying amount of our commercial mortgage loan portfolio was \$11,279.3 million and \$10,763.5 million as of December 31, 2008 and 2007, respectively. Commercial mortgage loans on real estate are generally reported at cost adjusted for amortization of premiums and accrual of discounts, computed using the interest method and net of valuation allowances. Commercial mortgage loans held for sale are carried at the lower of cost or fair value, less cost to sell, and reported as mortgage loans in the statements of financial position.

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

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

enhancing total returns and

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providing strategic portfolio diversification.

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

Our commercial mortgage loan portfolio consists of primarily non-recourse, fixed rate mortgages on fully or near fully leased properties. The mortgage portfolio is comprised primarily of credit oriented retail properties, manufacturing office properties and general-purpose industrial properties. In addition, we have a \$261.3 million short-term high rate portfolio of mortgages held by the spread business within the Global Asset Management segment. For geographic and property type distribution of our commercial mortgage loans, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 6, Investments."

Credit extensions in the state of California accounted for 20% of our commercial mortgage loan portfolio as of December 31, 2008. We are, therefore, exposed to potential losses resulting from the risk of catastrophes, such as earthquakes, that may affect the region. Like other lenders, we generally do not require earthquake insurance for properties on which we make commercial mortgage loans. With respect to California properties, however, we obtain an engineering report specific to each property. The report assesses the building's design specifications, whether it has been upgraded to meet seismic building codes and the maximum loss that is likely to result from a variety of different seismic events. We also obtain a report that assesses, by building and geographic fault lines, the amount of loss our commercial mortgage loan portfolio might suffer under a variety of seismic events.

Our commercial loan portfolio is highly diversified by borrower. As of December 31, 2008, 30% of the commercial mortgage loan portfolio was comprised of mortgage loans with principal balances of less than \$10.0 million. The total number of commercial mortgage loans outstanding was 1,223 and 1,254 as of December 31, 2008 and 2007, respectively. The average loan size of our commercial mortgage portfolio was \$9.3 million as of December 31, 2008.

**Commercial Mortgage Loan Credit Monitoring.** We actively monitor and manage our commercial mortgage loan portfolio. Substantially all loans within the portfolio are analyzed regularly and are internally rated, based on a proprietary risk rating cash flow model, in order to monitor the financial quality of these assets. Based on ongoing monitoring, mortgage loans with a likelihood of becoming delinquent are identified and placed on an internal "watch list". Among criteria which would indicate a potential problem are: imbalances in ratios of loan to value or contract rents to debt service, major tenant vacancies or bankruptcies, borrower sponsorship problems, late payments, delinquent taxes and loan relief/restructuring requests.

We review our mortgage loan portfolio and analyze the need for a valuation allowance for any loan which is delinquent for 60 days or more, in process of foreclosure, restructured, on the "watch list" or which currently has a valuation allowance. We categorize loans that are 60 days or more delinquent, loans in process of foreclosure, and loans to borrowers in bankruptcy that are delinquent as "problem" loans. Valuation allowances have been recognized on problem loans. Potential problem loans are loans placed on an internal "watch list" for which management has concerns as to the ability of the borrower to comply with the present loan payment terms and which may result in the loan becoming a problem or being restructured. The decision whether to classify a performing loan as a potential problem involves significant subjective judgments by management as to the likely future economic conditions and developments with respect to the borrower. We categorize loans for which the original Note Rate or Pay Rate of the mortgages have been reduced as "restructured" loans. We also consider matured loans that are refinanced at below market rates as restructured.

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

	December 31, 2008	December 31, 2007
	(\$ in millions)	
Total commercial mortgages	\$ 11,279.3	\$ 10,763.5
Problem commercial mortgages (1)	\$ 69.0	\$ 35.8
Potential problem commercial mortgages (2)	110.0	14.5
Restructured commercial mortgages (3)	5.5	14.8
Total problem, potential problem and restructured commercial mortgages	\$ 184.5	\$ 65.1
Total problem, potential problem and restructured commercial mortgages as a percent of total commercial mortgages	1.64%	.60%

(1)

Includes three mortgages held within the Global Asset Management segment as of December 31, 2008 and two mortgages held within the Global Asset Management segment as of December 31, 2007. One of these loans totaling \$26.0 million was in foreclosure as of December 31, 2008, and one mortgage loan totaling \$13.0 million was in

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foreclosure as of December 31, 2007. The loan in foreclosure as of December 31, 2008, was not in foreclosure as of December 31, 2007.

- (2) Potential problem commercial mortgages include \$48.0 million in mortgages held by the Global Asset Management segment at December 31, 2008, and \$14.5 million at December 31, 2007.
- (3) Includes one mortgage held within the Global Asset Management segment totaling \$5.5 million at December 31, 2008, and \$8.1 million at December 31, 2007.

**Commercial Mortgage Loan Valuation Allowance** The valuation allowance for commercial mortgage loans includes a loan specific allowance for impaired loans and a provision for losses based on past loss experience believed to be adequate to absorb estimated probable credit losses. The changes in the valuation allowance are reported in net income on our consolidated statements of operations.

Commercial mortgage loans on real estate are considered impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to contractual terms of the loan agreement. When we determine that a loan is impaired, a valuation allowance is established for the difference between the carrying amount of the mortgage loan and the estimated value. Estimated value is based on either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or fair value of the collateral.

When a valuation allowance is established, subsequent recoveries are credited to the valuation allowance and subsequent losses may be charged to the valuation allowance. The determination of the calculation and the adequacy of the mortgage loan loss provision based on past experience and current portfolio statistics are subjective. Our periodic evaluation and assessment of the adequacy of the provision for losses and the need for mortgage impairments is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of the underlying collateral, composition of the loan portfolio, current economic conditions, loss experience and other relevant factors. The evaluation of our impaired loan component of the allowance is subjective, as it requires estimating the amounts and timing of future cash flows expected to be received on impaired loans.

The current portfolio statistics and past loss experience produced a commercial mortgage loan general valuation allowance for the Principal Life general account totaling \$30.1 million. Our financial position is sensitive to changes in estimated cash flows from mortgages, the value of the collateral and changes in the economic environment in general. The valuation allowance for PFG increased by \$14.2 million for the year ended December 31, 2008, and increased by \$10.6 million for the year ended December 31, 2007. These increases are primarily related to net specific reserves taken on certain problem loans of \$16.2 million and \$10.0 million as of December 31, 2008, and December 31, 2007, respectively.

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

	December 31, 2008	December 31, 2007
	(\$ in millions)	
Balance, beginning of period	\$ 42.8	\$ 32.2
Provision	42.9	10.8
Releases	(28.7)	(0.2)
Balance, end of period	\$ 57.0	\$ 42.8
Valuation allowance as % of carrying value before reserves	.50%	.40%

### **Real Estate**

Real estate consists primarily of commercial equity real estate. As of December 31, 2008 and 2007, the carrying amount of equity real estate investment was \$915.2 million and \$859.6 million, respectively, or 1% of U.S. invested assets. Our commercial equity real estate is held in the form of wholly owned real estate, real estate acquired upon foreclosure of commercial mortgage loans and majority owned interests in real estate joint ventures.

Equity real estate is categorized as either "real estate held for investment" or "real estate held for sale." Real estate held for investment totaled \$779.8 million and \$777.2 million as of December 31, 2008 and 2007, respectively. The carrying value of real estate held for investment is generally adjusted for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Such impairment adjustments are recorded as net realized losses and, accordingly, are reflected in our consolidated results of operations. For the years ended December 31, 2008 and 2007, there were no such impairment adjustments.





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The carrying amount of real estate held for sale as of December 31, 2008, was \$135.4 million, net of valuation allowance of \$3.5 million. The carrying amount of real estate held for sale as of December 31, 2007, was \$82.4 million. There was no valuation allowance at December 31, 2007. Once we identify a real estate property to be sold and commence a plan for marketing the property, we classify the property as held for sale. We establish a valuation allowance subject to periodic revisions, if necessary, to adjust the carrying value of the property to reflect the lower of its current carrying value or the fair value, less associated selling costs.

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

Equity real estate is distributed across geographic regions of the country with larger concentrations in the South Atlantic, West South Central and Pacific regions of the United States as of December 31, 2008. By property type, there is a concentration in office, industrial site buildings, and retail that represented approximately 79% of the equity real estate portfolio as of December 31, 2008.

### Other Investments

Our other investments totaled \$2,162.4 million as of December 31, 2008, compared to \$1,391.4 million as of December 31, 2007. Derivatives accounted for \$1,873.2 million in other investments as of December 31, 2008. The remaining invested assets include equity method investments, which include properties owned jointly with venture partners and operated by the partners.

### International Investment Operations

Of our invested assets, \$3.3 billion were held by our International Asset Management and Accumulation segment as of December 31, 2008. Our international investment operations consist of the investments of Principal International. Principal Global Investors advises each Principal International affiliate on investment policies and strategies that are consistent with the products they offer. Due to the regulatory constraints in each country, each company maintains its own investment policies. As shown in the following table, the major categories of international invested assets as of December 31, 2008 and 2007, were fixed maturity securities, other investments and residential mortgage loans. The following discussion analyzes the composition of general account assets, but excludes invested assets of the separate accounts.

		December 31, 2008		December 31, 2007	
		Carrying amount	% of total	Carrying amount	% of total
(\$ in millions)					
Fixed maturity securities	Public	\$ 2,134.2	64%	\$ 2,719.5	67%
Equity securities		40.8	1	52.7	1
Mortgage loans	Residential	479.9	14	558.6	14
Real estate		4.2		2.9	
Policy loans		15.0	1	16.2	
Other investments		654.2	20	727.2	18
Total invested assets		3,328.3	100%	4,077.1	100%
Cash and cash equivalents		71.0		82.9	
Total invested assets and cash		\$ 3,399.3		\$ 4,160.0	

Investments in equity method subsidiaries and direct financing leases accounted for \$377.2 million and \$265.4 million, respectively, of other investments as of December 31, 2008. Investments in equity method subsidiaries and direct financing leases accounted for \$455.6 million and \$256.3 million, respectively, of other investments as of December 31, 2007. The remaining invested assets as of December 31, 2008, and December 31, 2007, are primarily related to derivatives and seed money.

### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

#### Market Risk Exposures and Risk Management

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



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

rebalance our existing asset or liability portfolios;

control the risk structure of newly acquired assets and liabilities or

use derivative instruments to modify the market risk characteristics of existing assets or liabilities or assets expected to be purchased.

### Interest Rate Risk

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

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

We manage interest rate risks in a number of ways. Differences in durations between assets and liabilities are measured and kept within acceptable tolerances. Derivatives are also commonly used to mitigate interest rate risk due to cash flow mismatches and timing differences. Prepayment risk is controlled by limiting our exposure to investments that are prepayable without penalty prior to maturity at the option of the issuer. We also require additional yield on these investments to compensate for the risk the issuer will exercise such option. Prepayment risk is also controlled by limiting the sales of liabilities with features such as puts or other options that can be exercised against the company at inopportune times. For example, approximately \$19.1 billion, or 98%, of our institutional GICs and funding agreements cannot be redeemed by contractholders prior to maturity.

We are also exposed to interest rate risk based upon the discount rate assumption used for purposes of valuing our pension and other postretirement benefit obligations. For further discussion of interest rate risk associated with these obligations, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operation Critical Accounting Policies and Estimates Benefit Plans."

**Duration-Managed.** Our exposure to interest rate risk stems largely from our substantial holdings of guaranteed fixed rate liabilities in our U.S. Asset Accumulation segment. We actively manage the duration of assets and liabilities in these products by minimizing the difference between the two. We have established a maximum tolerance for this difference and seek to stay within this tolerance.

As of December 31, 2008, the difference between the asset and liability durations on our primary duration-managed portfolio was -0.17, as compared to -0.01 as of December 31, 2007. This duration gap indicates that, as of December 31, 2008, the sensitivity of the fair value of our assets to interest rate movements is less than that of the fair value of our liabilities. Our goal is to minimize the duration gap. Currently, our guidelines indicate that total duration gaps between the asset and liability portfolios should be within +/-0.25. The value of the assets in this portfolio was \$29,440.1 million and \$33,183.4 million as of December 31, 2008 and 2007, respectively.

**Duration-Monitored.** For products such as whole life insurance and term life insurance that are less sensitive to interest rate risk, and for other products such as individual single premium deferred annuities, we manage interest rate risk based on a modeling process that considers the target average life, maturities, crediting rates and assumptions of policyholder behavior. As of December 31, 2008, the weighted-average difference between the asset and liability durations on these portfolios was +0.09, as compared to +0.22 as of December 31, 2007. This duration gap indicates that, as of December 31, 2008, the sensitivity of the fair value of our assets to interest rate movements is greater than that of the fair value of our liabilities. We attempt to monitor this duration gap consistent with our overall risk/reward tolerances. The value of the assets in these portfolios was \$18,017.3 million and \$17,990.9 million as of December 31, 2008 and 2007, respectively.

**Non Duration-Managed.** We also have a block of participating general account pension business that passes most of the actual investment performance of the assets to the customer. The investment strategy of this block is to maximize investment return to the customer on

a "best efforts" basis, and there is little or no attempt to manage the duration of

this portfolio since there is little or no interest rate risk. The value of the assets in these portfolios was \$4,866.0 million and \$5,234.0 million as of December 31, 2008 and 2007, respectively.

Using the assumptions and data in effect as of December 31, 2008, we estimate that a 100 basis point immediate, parallel increase in interest rates increases the net fair value of our portfolio by approximately \$34.0 million, compared with an estimated \$36.3 million decrease as of December 31, 2007. The following table details the estimated changes by risk management strategy. The table also gives the weighted-average duration of the asset portfolio for each category, and the net duration gap (i.e., the weighted-average difference between the asset and liability durations).

Risk Management Strategy	Value of total assets  (in millions)	Duration of assets	December 31, 2008	
			Net duration gap	Net fair value change (in millions)
Primary duration-managed	\$ 29,440.1	3.05	(0.17)	\$ 50.0
Duration-monitored	18,017.3	4.53	0.09	(16.0)
Non duration-managed	4,866.0	5.07	N/A	N/A
Total	\$ 52,323.4			\$ 34.0

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

See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operation Critical Accounting Policies and Estimates Valuation of Invested Assets" for additional discussion of the impact interest rate increases would have on fixed maturities, available-for-sale.

**Debt Issued and Outstanding.** As of December 31, 2008 and 2007, the aggregate fair value of long-term debt was \$1,096.1 million and \$1,423.6 million, respectively. As of December 31, 2008, a 100 basis point immediate, parallel decrease in interest rates would increase the fair value of debt by approximately \$59.4 million, as compared to an estimated \$106.3 million increase as of December 31, 2007. Debt is not recorded at fair value on the statement of financial position.

Using the assumptions and data in effect as of December 31, 2008, we estimate that a 100 basis point immediate, parallel decrease or increase in interest rates would increase or decrease, respectively, the fair value for each category of long-term debt as presented in the following table.

	December 31, 2008		
	Fair value (no accrued interest)		
	-100 basis point change	No change	+100 basis point change
	(in millions)		
8.2% notes payable, due 2009	\$ 469.3	\$ 468.7	\$ 466.0
3.31% notes payable, due 2011	51.8	50.4	49.1
3.63% notes payable, due 2011	26.7	26.0	25.4
6.05% notes payable, due 2036	450.7	404.4	365.4
8% surplus notes payable, due 2044	99.1	89.6	81.1
Non-recourse mortgages and notes payable	57.3	56.4	55.6
Other mortgages and notes payable	0.6	0.6	0.6
Total long-term debt	\$ 1,155.5	\$ 1,096.1	\$ 1,043.2

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

**Use of Derivatives to Manage Interest Rate Risk.** We use various derivative financial instruments to manage our exposure to fluctuations in interest rates, including interest rate swaps, swaptions, futures, treasury lock agreements and

options. We use interest rate swaps and futures contracts to hedge changes in interest rates subsequent to the issuance of an insurance liability, such as a guaranteed investment contract, but prior to the purchase of a supporting asset, or during periods of holding assets in anticipation of near term liability sales. We use interest rate swaps primarily to more closely match the interest rate characteristics of assets and liabilities. They can be used to change the sensitivity to the interest rate of specific assets and liabilities as well as an entire portfolio. Prior to the termination of our commercial mortgage securities operation, we used these instruments to hedge the interest rate exposure within the operation. Occasionally, we will sell a callable investment-type agreement and will use written interest rate swaptions to transform the callable liability into a fixed term liability.

### Foreign Currency Risk

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from foreign currency-denominated funding agreements issued to nonqualified institutional investors in the international market, foreign currency-denominated fixed maturity securities and demand deposits purchased and our international operations.

We estimate that as of December 31, 2008, a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we are exposed would result in no material change to the net fair value of our foreign currency denominated instruments identified above because we effectively hedge foreign currency denominated instruments to minimize exchange rate impacts, which is consistent with our estimate as of December 31, 2007. However, fluctuations in foreign currency exchange rates do affect the translation of local operating earnings and equity into our consolidated financial statements.

For our International Asset Management and Accumulation segment, we estimate that a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we were exposed would have resulted in a \$100.3 million, or 10%, reduction in the total equity of our international operations as of December 31, 2008, as compared to an estimated \$143.2 million, or 10%, reduction as of December 31, 2007. In addition, a 10% unfavorable change in the average foreign currency exchange rates to which we were exposed through our international operations would have resulted in a \$12.7 million, or 10%, reduction in the annual operating earnings of our international operations for the years ended December 31, 2008, as compared to an estimated \$13.1 million, or 12%, reduction for the year ended December 31, 2007.

The selection of a 10% immediate unfavorable change in all currency exchange rates should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event. These exposures will change as a result of a change in the size and mix of our foreign operations.

**Use of Derivatives to Manage Foreign Currency Risk.** The foreign currency risk on funding agreements and fixed maturity securities is mitigated by using currency swaps that swap the foreign currency interest and principal payments to our functional currency. The notional amount of our currency swap agreements associated with foreign-denominated liabilities was \$4,269.2 million and \$4,351.7 million as of December 31, 2008 and 2007, respectively. The notional amount of our currency swap agreements associated with foreign-denominated fixed maturity securities was \$2,005.4 million and \$1,973.4 million as of December 31, 2008 and 2007, respectively.

With regard to our international operations, we attempt to do as much of our business as possible in the functional currency of the country of operation. At times, however, we are unable to do so, and in these cases, we use foreign exchange derivatives to economically hedge the resulting risks. Our operations in Chile had currency swaps with a notional amount of \$24.1 million as of both December 31, 2008 and 2007, that were used to swap cash flows on U.S. dollar-denominated bonds to a local currency. Chile also utilized currency forwards with a notional amount of \$52.1 million and \$134.1 million as of December 31, 2008 and 2007, respectively, in order to mitigate currency exposure related to bonds denominated in currencies other than Chilean pesos.

Additionally, from time to time we take measures to hedge our net equity investments in our foreign subsidiaries from currency risks. There were no outstanding net equity investment hedges in 2008 or 2007.

### Equity Risk

Equity risk is the risk that we will incur economic losses due to adverse fluctuations in a particular common stock. As of December 31, 2008 and 2007, the fair value of our equity securities was \$400.7 million and \$586.2 million, respectively. As of December 31, 2008, a 10% decline in the value of the equity securities would result in an unrealized loss of \$40.1 million, as compared to an estimated unrealized loss of \$58.6 million as of December 31, 2007.

We are also exposed to the risk that asset-based fees decrease as a result of declines in assets under management due to change in investment prices and the risk that asset management fees calculated by reference to performance could be lower. We estimate that an immediate 10% decline in the Standard & Poor's index, followed by a 2% per quarter increase would reduce our annual operating earnings by



approximately four to six percent. The risk of decreased asset-based and asset management fees could also impact our estimates of total gross profits used as a basis for amortizing deferred policy

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acquisition and other costs. For further discussion, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operation Critical Accounting Policies and Estimates Deferred Policy Acquisition Costs and Other Actuarial Balances."

The selection of a 10% unfavorable change in the equity markets should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event. Our exposure will change as a result of changes in our mix of business.

We also have equity risk associated with (1) fixed deferred annuity contracts that credit interest to customers based on changes in an external equity index; (2) variable annuity contracts that have a GMWB rider that allows the customer to receive at least the principal deposit back through withdrawals of a specified annual amount, even if the account value is reduced to zero; (3) variable annuity contracts that have a GMDB that allows the death benefit to be paid, even if the account value has fallen below the GMDB amount; (4) investment-type contracts in which the return is tied to an external equity index and (5) investment-type contracts in which the return is subject to minimum contractual guarantees. We are also subject to equity risk based upon the assets that support our benefit plans. For further discussion of equity risk associated with these plans, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operation Critical Accounting Policies and Estimates Benefit Plans."

**Use of Derivatives to Manage Equity Risk.** We economically hedge the fixed deferred annuity product by purchasing options that match the product's profile. We economically hedge the GMWB exposure using futures, options and interest rate swaps. We economically hedge the investment contract exposure to an external equity index using equity call options.

The fair value of both the GMWB embedded derivative and associated hedging instruments are sensitive to financial market conditions and the variance related to the change in fair value of these items for a given period is largely dependent on market conditions at the end of the period. For the year ended December 31, 2008, we recognized a \$37.4 million pre-tax loss on the change in fair value of the GMWB embedded derivative and a \$171.5 million pre-tax gain on the derivatives used to economically hedge our GMWB market risk, which includes equity risk. The implementation of SFAS 157 in 2008 resulted in the incorporation of a spread reflecting our own creditworthiness and additional risk margins in the valuation of the GMWB embedded derivative. Throughout 2008, the spread reflecting our own credit risk increased, which drove a significant increase in the discount rates applied, thereby reducing the level of pre-tax loss from fair value changes in the embedded derivative. This resulted in the pre-tax loss from the fair value of the embedded derivative being significantly different than the pre-tax gain from the fair value changes in the associated hedging instruments. Additionally, the net gain from the change in value of the GMWB embedded derivative and the associated hedging instruments resulted in a \$45.4 million pre-tax increase in DPAC amortization.

### Credit Risk

Credit risk relates to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest. Our ability to manage credit risk is essential to our business and our profitability. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Investments" for additional information about credit risk.

**Use of Derivatives to Diversify or Hedge Credit Risk.** We sometimes purchase credit default swaps to hedge credit exposures in our investment portfolio. We sell credit default swaps to offer credit protection to investors. When selling credit protection, if there is an event of default by the referenced name, we are obligated to pay the counterparty the referenced amount of the contract and receive in return the referenced security. For further information on credit derivatives sold, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 8, Derivative Financial Instruments."

We economically hedged credit exposure in our portfolio by purchasing credit default swaps with a notional amount of \$549.0 million and \$63.4 million as of December 31, 2008 and 2007, respectively. As of December 31, 2008, we did not have any credit default swaps hedging spread risk in our portfolio. At December 31, 2007, we utilized credit default swaps with a notional amount of \$69.5 million to economically hedge spread risk in our portfolio. We had credit exposure through credit default swaps with a notional amount of \$200.0 million as of both December 31, 2008 and 2007, by investing \$200.0 million in various tranches of synthetic collateralized debt obligations. In addition, we sold credit default swaps creating replicated assets with a notional amount of \$1,199.9 million and \$801.9 million as of December 31, 2008 and 2007, respectively.

### Derivative Summary

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 amount is not a quantification of market risk or credit risk and it may not necessarily be recorded on the statement of financial position. 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. Actual credit exposure represents the amount owed to us under derivative contracts as of the valuation



date. The following tables present our position in, and credit exposure to, derivative financial instruments as of December 31, 2008 and 2007.

### Derivative Financial Instruments Notional Amounts

	December 31, 2008		December 31, 2007	
	Notional amount	% of total	Notional amount	% of total
(\$ in millions)				
Interest rate swaps	\$ 24,148.6	66%	\$ 18,627.3	62%
Foreign currency swaps	6,298.7	17	6,349.2	21
Embedded derivative financial instruments	2,940.4	8	2,088.9	7
Credit default swaps	1,948.9	6	1,134.8	4
Options	797.5	2	572.0	2
Futures	161.0	1	57.7	
Swaptions	94.8		488.8	2
Currency forwards	52.1		361.9	1
Commodity swaps	40.0		40.0	
Treasury lock agreements			150.0	1
Total	\$ 36,482.0	100%	\$ 29,870.6	100%

### Derivative Financial Instruments Credit Exposures

	December 31, 2008		December 31, 2007	
	Credit exposure	% of total	Credit exposure	% of total
(\$ in millions)				
Interest rate swaps	\$ 1,105.1	56%	\$ 286.0	24%
Foreign currency swaps	562.5	29	805.5	69
Options				