PRINCIPAL FINANCIAL GROUP INC
Form 10-K
February 15, 2012

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, 2011

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	**711 High Street,**	**42-1520346**
(State or other jurisdiction of incorporation or organization)	**Des Moines, Iowa 50392**	(I.R.S. Employer Identification Number)
	(Address of principal executive offices)	

(515) 247-5111

(Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01	New York Stock Exchange
Series B Non-Cumulative Perpetual Preferred Stock	New York Stock Exchange
Securities registered pursuant to Section 12(g) of the Act:	
Series A Non-Cumulative Perpetual Preferred Stock	

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

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 ý No o

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

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. ý

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 ý	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o

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

As of February 8, 2012, there were outstanding 301,454,134 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 $9,542,992,614 based on the closing price of $30.42 per share of Common Stock on the New York Stock Exchange on June 30, 2011.

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 22, 2012, 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, 2011.

Table of Contents

PRINCIPAL FINANCIAL GROUP, INC.
TABLE OF CONTENTS

Table of Contents

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."

Table of Contents

PART I

Item 1. Business

Principal Financial Group, Inc. ("PFG") is a leading provider of retirement savings, investment and insurance products and services with $335.0 billion in assets under management ("AUM") and approximately 18.0 million customers worldwide as of December 31, 2011.

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, 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. 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:

- Retirement and Investor Services;
- Principal Global Investors;
- Principal International and
- U.S. Insurance Solutions.

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 16, 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.

Retirement and Investor Services 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 Individual Retirement Accounts ("IRA") and payroll deduction plans;

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 savings for retirement and other purposes through mutual funds, individual annuities and bank products.

We organize our Retirement and Investor Services 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.

Table of Contents

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, a mutual fund offering or a collective investment trust. In addition, defined contribution plans may also offer their own employer security as an investment option.

As of December 31, 2011, we provided full service accumulation products to over 29,600 defined contribution pension plans, of which approximately 24,200 were 401(k) plans, covering 3.2 million eligible plan participants, and to over 2,400 defined benefit pension plans, covering over 325,000 eligible plan participants. As of December 31, 2011, approximately 61% 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 our Principal Global Investors segment 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 2010, only 24% of businesses with between 10 and 49 employees, 48% of businesses with between 50 and 99 employees, 55% of businesses with between 100 and 249 employees and 62% of businesses with between 250 and 500 employees offered a 401(k) plan. The same study indicates that 73% of employers with between 500 and 1,000 employees, 84% 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 2010.

We distribute our full service accumulation products and services nationally, primarily through a captive retirement services sales force. As of December 31, 2011, over 110 retirement services sales representatives in over 42 offices, operating as a wholesale distribution network, maintained relationships with over 11,600 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, 2011, we had a separate staff of over 280 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 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. The Principal Retirement Income Edge® program provides education and 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.

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.

Table of Contents

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 December 2011, as reported by the Strategic Insight, we are ranked 21st according to AUM (long term funds) of the top 50 intermediary sold mutual funds. We provide accounting, compliance, corporate governance and product development for all mutual funds we organize. As of December 31, 2011, our mutual fund operations served approximately 1.1 million mutual fund shareholder accounts.

Principal Funds, Inc. Principal Funds, Inc. ("PFI") is a series mutual fund that, as of December 31, 2011, offered 63 investment options. This fund's five R class shares act as the funding vehicle for Principal Advantage, the defined contribution product described above under "Retirement and Investor Services Segment Full Service Accumulation Products." This fund also offers three retail classes of shares to individuals. One of the three retail share classes is for IRA rollovers (J shares) and two are for general investment purposes (A and C shares). Two additional classes of shares are available: (1) I shares, which are offered primarily to specified institutional investors, and (2) P shares, which are used primarily in adviser fee-based programs. As of December 31, 2011, the retail classes of shares had $24.4 billion of AUM. All other share classes of Principal Funds, Inc. had $39.2 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 that, as of December 31, 2011, provided 34 investment options for variable annuity and variable life insurance contracts issued by Principal Life Insurance Company ("Principal Life") and other insurance companies not affiliated with Principal Life. As of December 31, 2011, this fund had $5.3 billion of 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 U.S. Insurance Solutions segment.

Principal Managed Portfolio. Principal Managed Portfolio is an advisory 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 product. As of December 31, 2011, Principal Managed Portfolio had accumulated $608.0 million in assets.

Principal Advisory Select and Principal Dynamic Portfolios. These are advisory products 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 these products. As of December 31, 2011, these products had accumulated $1.6 billion in assets.

Markets and Distribution

Our markets for PFI's retail share classes are individuals seeking to accumulate savings for retirement and other purposes, as well as nonqualified individual savings plans utilizing payroll deductions. We also market PFI's retail share classes to participants in pension plans who are departing their plans and reinvesting their retirement assets into individual retirement accounts.

We sell PFI's retail share classes primarily through registered representatives from other broker-dealers; affiliated financial representatives; independent brokers registered with our securities broker-dealer, Princor; direct deposits from our employees and others and Principal Connection. As of December 31, 2011, 58 retail sales representatives across the United States, operating as a wholesale distribution network, maintained relationships with over 36,700 independent brokers, consultants and agents. 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 through Principal Connection.

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 number of years. Thereafter, we reset, typically annually, the interest rate credited to the contract based upon our discretion, subject to contractual minimums, by taking into account market and other conditions. We also offer a fixed deferred annuity where the interest credited is linked to an external equity index, subject to maximum and minimum values. 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

Table of Contents

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. The Principal Global Investors segment 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 the Principal Global Investors segment or other third-party asset managers. As of December 31, 2011, 83% of our $5.7 billion in variable annuity account balances was allocated to investment sub-accounts and our general account, which are managed by the Principal Global Investors segment and 17% 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 elect a living benefit guarantee (commonly known in the industry as a guaranteed minimum withdrawal benefit, or "GMWB"). We bear the GMWB investment risk. We attempt to hedge the GMWB investment risk through the use of sophisticated risk management techniques. As of December 31, 2011, $2.8 billion of the $5.7 billion of variable annuity account value had 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. The Principal Global Investors segment 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 individuals for both qualified and nonqualified retirement savings.

We sell our individual annuity products through our affiliated financial representatives, who accounted for 50%, 43% and 34% of annuity sales for the years ended December 31, 2011, 2010 and 2009, respectively. The remaining sales were made through banks, brokerage general agencies, mutual fund companies, Principal Connection and unaffiliated broker-dealer firms. Affiliated financial representatives continued to be the primary distribution channel of our variable deferred annuities. The majority of overall annuity sales, however, were from non-affiliated distribution channels, as a result of focused efforts to increase fixed annuity sales through non-affiliated distribution channels.

Bank and Trust Services

Bank and trust services includes Principal Bank and Principal Trust Company. Principal Bank is a federal savings bank that began its activities in February 1998. As of December 31, 2011, Principal Bank had over 240,000 customers and approximately $2.4 billion in assets. Delaware Charter Guarantee & Trust Company, dba Principal Trust Company, is a Delaware state chartered non-deposit trust company that was chartered in 1899. It is one of the largest non-deposit trust companies in the U.S. As of December 31, 2011, we served as trustee to over 436,000 accounts, which held assets of approximately $103.7 billion. Principal Trust Company may not accept deposits and cannot make personal or commercial loans.

Products

Our current bank products and services include a suite of consumer checking and savings accounts, money market accounts, certificates of deposit ("CDs"), individual retirement accounts and small account rollovers from qualified retirement plans. In addition, we offer deposit and loan services to small and medium-sized businesses. Principal Bank participates in the Certificate of Deposit Account Registry Service program through which certain customer CDs are exchanged for CDs of similar amounts from participating banks. The deposit products provide a relatively stable source of funding and liquidity and are used to fund purchases of investment securities and loans.

Principal Trust Company specializes in providing trust solutions for a full array of employee benefit plans and accounts including 401(k) and 403(b) plans, defined benefit pension plans, nonqualified executive benefit plans, ESOPs, and self-directed tax-advantaged savings accounts, such as IRAs. Principal Trust Company also maintains a series of collective investment funds, The Principal Trust^{SM} Target Date

Funds, and provides personal trust services.

Table of Contents

Markets and Distribution

We offer our bank products and services to employees of businesses and other individuals, through Principal Connection, our affiliated financial representatives and other PFG affiliates with a primary focus on helping customers accumulate savings for retirement and other purposes. We also pursue asset retention strategies with customers who seek to transfer assets from our other asset accumulation products by offering them our banking products and services. Principal Bank services customers through the telephone, mail and Internet.

We deliver our directed trust services to customers through our PFG affiliates. Administrative trust services for self-directed tax-advantaged savings accounts are sold 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. The Principal Global Investors segment 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.

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 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. The Principal Global Investors segment 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.

Table of Contents

Principal Global Investors Segment

Our Principal Global Investors segment manages assets for sophisticated investors around the world, using a multi-boutique strategy that enables the segment to provide an expanded range of diverse investment capabilities including equity, fixed income and real estate investments. We also have experience in currency management, asset allocation, stable value management and other structured investment strategies. We focus on providing services to our other segments and third-party institutional clients. We maintain offices in Australia, Brazil, Dubai, Germany, Hong Kong, Japan, Netherlands, Singapore, the United Kingdom and the United States.

We deliver our products and services through our network of specialized investment groups and boutiques including Principal Global Investors Equities; Principal Global Investors Fixed Income; Principal Real Estate Investors; Principal Enterprise Capital; Spectrum Asset Management; Post Advisory Group, LLC; Columbus Circle Investors; Edge Asset Management; Morley Financial Services; Macro Currency Group; Finisterre Capital LLP and Origin Asset Management LLP. Additionally, Multi-Asset Advisors was established during 2011 to provide advice on multi-asset strategies to clients globally and to manage customized multi-asset products. As of December 31, 2011, Principal Global Investors and its boutiques managed $227.8 billion in assets.

Products and Services

Our products and services are provided for a fee as defined by client mandates. Our fees are generally driven by AUM. We are diversified across three primary asset classes.

Equity Investments. As of December 31, 2011, Principal Global Investors Equities along with Columbus Circle Investors, Edge Asset Management and Origin Asset Management LLP managed $68.4 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, 2011, 42% of equity AUM was derived from our pension products, 25% from other products of PFG and the remaining 33% from third-party institutional clients.

Fixed Income Investments. As of December 31, 2011, Principal Global Investors Fixed Income along with Spectrum Asset Management; Post Advisory Group, LLC; Edge Asset Management; Morley Financial Services and Finisterre Capital LLP managed $116.2 billion in global fixed income assets. Collectively, our experience in fixed income management spans multiple economic and credit market cycles, and encompasses all major fixed income sectors and security types. Our research and risk management capabilities in worldwide debt markets provide a strong foundation for broadly diversified "multi-sector" portfolios, tailored to specific client objectives. As of December 31, 2011, 33% of these assets were derived from our pension products, 33% from other products of PFG, and the remaining 34% from third-party institutional clients.

Real Estate Investments. Principal Global Investors, through its affiliates Principal Real Estate Investors and Principal Enterprise Capital, managed a portfolio of primarily U.S. commercial real estate assets of $38.7 billion as of December 31, 2011. Principal Real Estate Investors provides our clients with a broad range of real estate investment options including private real estate equity, commercial mortgages, bridge/mezzanine loans, commercial mortgage-backed securities and real estate investment trust securities. As of December 31, 2011, 28% of the commercial real estate portfolio was derived from our pension products, 29% from other products of PFG and the remaining 43% from third-party institutional clients.

Other. We offer products and services through other asset classes including managing currency mandates through our Macro Currency Group boutique. As of December 31, 2011, we managed $4.5 billion with 100% of these assets derived from third-party institutional clients.

Multi-Asset Advisors was established during 2011 to provide advice on multi-asset strategies to global clients and to develop and manage customized multi-asset products to address specific client needs. Multi-Asset Advisors helps Principal Global Investors optimize our broad range of capabilities while enhancing our position as a thought leader and trusted advisor to large institutional clients.

Markets and Distribution

We employed 103 institutional sales, relationship management and client service professionals as of December 31, 2011, who worked with consultants and directly with large investors to acquire and retain third-party institutional clients. As of December 31, 2011, Principal Global Investors and its boutiques had approximately 647 third-party institutional clients with $82.4 billion of AUM in 35 countries.

Principal International Segment

Our Principal International segment has operations in Brazil, Chile, China, Hong Kong Special Administrative Region ("SAR"), India, Mexico and Southeast Asia. We focus on countries with large middle classes, favorable demographics, and growing long-term savings, ideally with defined contribution retirement markets. We entered these locations through acquisitions, start-up operations and joint ventures.

The activities of our Principal International segment 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-

Table of Contents

term savings. Through the Principal International segment, we offer retirement products and services, annuities, mutual funds, institutional asset management and life insurance accumulation products.

Products, Markets and Distribution

Brazil. We offer pension, retirement income and asset accumulation products through a co-managed joint venture, Brasilprev Seguros e Previdencia ("Brasilprev") in which PFG owns 25% of the economic interest and 50.01% of the voting shares. The partner is Banco do Brasil ("Banco"), which had approximately 5,140 Brazilian branches as of September 30, 2011. Brasilprev has an exclusive agreement with Banco to distribute pension, retirement and long-term asset accumulation products. Our joint venture provides defined contribution products, complementary life protection and payout solutions for the retirement needs of employers and individuals. Banco'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's corporate account executives selling to existing and prospective corporate clients. According to Federação Nacional de Previdência e Vida, our joint venture ranked third in the Brazilian private pension market based upon managed assets as of November 30, 2011.

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

Retirement annuities are offered to individuals exiting the pre-retirement accumulation system. Annuity products are distributed through a network of brokers and independent agents numbering approximately 340 as of December 31, 2011.

We serve the individual and group voluntary/complementary long-term savings market by offering "APV plans" (qualified individual retirement solutions) and "APVC plans" (qualified group retirement solutions that are similar to the U.S. 401(k) product line). According to the Asociacion de Adminstradoras de Fondos Mutuous de Chile, we ranked first in AUM for mutual fund companies offering these plans in Chile as of November 30, 2011. The plans, together with non-qualified mutual fund products, are distributed to retail clients through our proprietary sales force, financial advisors, brokerage houses, alliances with financial institutions and the largest retailer in Chile, Falabella.

Life insurance accumulation products are also offered to individuals through brokers and financial advisors. We originate, sell and service individual residential mortgage loans in Chile through our independent distribution network, which is composed primarily of real estate brokers and developers. We also offer institutional asset management services to pension funds, insurance companies, mutual fund companies and investment platforms through our proprietary sales force.

China. We offer mutual funds and asset management services to individuals and institutions through a minority-held joint venture that includes China Construction Bank ("CCB"), the majority partner. We sell mutual funds primarily through our partner bank, CCB. The bank provides extensive distribution capabilities for the joint venture in terms of brand awareness and the number of branch outlets, which number approximately 13,630.

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

We actively compete in the defined contribution pension plan market. The government currently requires both employers and employees to each 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. Our alliance partners distribute our MPF products and services or use our administrative and investment services in their own products. We are expanding our distribution capability to complement our MPF and mutual fund businesses by developing a proprietary sales force that will focus on retirement and long-term investment products.

We sell mutual funds to retail customers primarily through strategic alliances with banks. To grow institutional asset management, our operations in Hong Kong SAR leverage Principal Global Investors' regional asset management and sales resources to jointly secure mandates.

India. We offer mutual funds and asset management services to both retail and corporate customers.

In the mutual funds market, we compete by managing and administering funds for both individuals and corporations through a majority-owned joint venture. The minority partners are Punjab National Bank and Vijaya Bank, two large Indian commercial banks with a combined network of approximately 6,350 branches. Mutual funds are sold 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 by developing a proprietary distribution company that will focus on retirement and long-term investment products.

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

On August 8, 2011, we finalized the purchase of our 100% interest in HSBC AFORE, S.A. de C.V. ("HSBC AFORE"), a Mexican pension business, from HSBC Bank. In addition, on November 23, 2011, we and Grupo Financiero HSBC signed an exclusive agreement for the distribution of Principal AFORE's products through Grupo Financiero

Table of Contents

HSBC's extensive network in Mexico. HSBC AFORE was merged into our AFORE pension company. Through our AFORE pension company we manage and administer approximately 4.3 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 approximately 1,240 sales representatives as of December 31, 2011, as well as independent brokers who sell directly to individuals.

Our mutual fund company distributes products and services through a sales force of approximately 35 employees and through distribution agreements with other financial entities. We administer previously sold annuities and life products. Due to unfavorable market conditions, sales of our annuity and life products in Mexico were suspended in 2007.

Mexico has institutional asset management services, offering both domestic and international products.

Southeast Asia. We offer conventional and Islamic mutual funds through our minority-held joint venture with CIMB Group, the majority partner. CIMB Group is a large Malaysian bank holding company with a presence in many Southeast Asian countries. The company has a sales force of approximately 5,960 agents selling to retail customers as of December 31, 2011. We also market mutual funds through wholesale bank channels. The joint venture's main bank channels include approximately 1,100 bank branches throughout Malaysia, Indonesia, Thailand and Singapore. CIMB-Principal Asset Management ranked second in total unit trust assets managed and second in Islamic unit trust assets managed in the Malaysian asset management industry as of November 30, 2011. The companies also manage a significant amount of institutional asset mandates.

The joint venture also has operations in Singapore (CIMB-Principal Asset Management (S) Pte Ltd), Indonesia (PT CIMB-Principal Asset Management) and Thailand (CIMB-Principal Asset Management Company Limited).

U.S. Insurance Solutions Segment

Our U.S. Insurance Solutions segment offers individual life insurance and specialty benefits, which include group dental, group vision, group life, group disability, wellness and individual disability insurance. We focus on providing comprehensive insurance solutions for small and medium-sized businesses and their owners and executives.

Individual Life Insurance

We began as an individual life insurer in 1879. Our U.S. operations administer approximately 542,000 individual life insurance policies with over $146.0 billion of individual life insurance in force as of December 31, 2011.

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.

Products and Services

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

Universal and Variable Universal Life Insurance. Universal and variable universal life insurance products offer the policyholder the option of adjusting both the premium and the death benefit amounts of the insurance contract. Universal life insurance typically 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, 2011, 78% of individual life insurance annualized first year premium sales were generated from universal and variable universal life insurance products. Universal and variable universal life insurance represents 67% of individual life insurance premium and deposits for the year ended December 31, 2011, and 47% of individual life insurance in force as of December 31, 2011. Variable universal life insurance products represented 28% of our universal and variable universal life insurance deposits for the year ended December 31, 2011.

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 the 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 Principal Life 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.

Table of Contents

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 represented 5% and 17%, respectively, of our individual life insurance annualized first year premium sales for the year ended December 31, 2011, and 16% and 37%, respectively, of individual life insurance in force as of December 31, 2011. Adjustable life insurance products provide a guaranteed benefit in return for the payment of a fixed premium and allow the policyholder to set the coverage period, 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.

Specialty Benefits Insurance

Specialty benefits insurance, which includes group dental, vision, life and disability insurance and individual 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 also offer group dental, vision, and disability on a fee-for-service basis. 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. Effective January 1, 2011, Principal Wellness Company, a provider of wellness services since 2004, transitioned to the Specialty Benefits Insurance division. Also effective January 1, 2011, our fee-for-service group dental, vision, and disability business transitioned to this division.

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, 2011, we had over 33,000 group dental and vision insurance policies in force covering over 896,000 employee lives. According to LIMRA, we were the 8th largest group dental insurer in terms of number of contracts/employer groups in force in 2010. 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 Employers 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, 2011, we had nearly 44,000 group policies providing over $109.0 billion of group life insurance in force to approximately 1.8 million employee lives. According to LIMRA in 2010, we were ranked 4th in the U.S. in terms of the number of group 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 97% and 3%, respectively, of our total group life insurance in force as of December 31, 2011. 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. In most instances, this benefit is in the form of a monthly income. 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 65% of total group disability premium, while short-term disability represents 35% 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, 2011, we served approximately 1.2 million employee lives under nearly 31,000 contracts, with our group short-term disability business being ranked 5th and our group long-term disability business being ranked 5th in the U.S. as of December 31, 2010, 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-related costs such as overhead expenses for a disabled business owner, buy-out costs for business owners purchasing a disabled owner's interest in the business, expenditures for replacement of a key person and business loan payments. As of December 31, 2011, we served approximately 140,000 individual disability policyholders, with our individual disability business being ranked 7th in the U.S. as of December 31, 2010, in terms of premium in force, according to LIMRA.

Principal Wellness Company. We recognize the importance of promoting healthy behavior. Principal Wellness Company contributes expertise in providing a year round wellness program, wellness screenings, counseling and other services to employers and their employees, designed to improve health, reduce health insurance claim costs, reduce absenteeism and increase employee productivity.

Fee-for-Service. We offer administration of group dental, disability and vision benefits on a fee-for-service basis.

U.S. Insurance Solutions 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 59% of individual life sales and 51% of individual disability sales for the year ended December 31, 2011. Much of our life insurance sales efforts focus on the Business Owner & Executive Solutions market. This strategy offers solutions to address business owner financial challenges such as exiting the business, business transition, retaining key employees and retirement planning. Key employees also have needs to supplement retirement income, survivor income, and business protection. We believe the Business Owner & Executive Solutions segment offers growth opportunities and we will continue to develop strategies to capitalize on this expanding market.

We distribute our individual life and individual disability insurance products through our affiliated financial representatives and independent brokers, as well as other marketing and distribution alliances. Affiliated financial representatives were responsible for 30% of individual life insurance sales based on first year annualized premium and 14% of individual disability sales for the year ended December 31, 2011. We had 1,013 affiliated financial representatives in 29 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 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, dental and vision products in all 50 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' dental, disability and vision benefits. We market our wellness and fee-for-service businesses in all 50 states and the District of Columbia.

The group insurance market continues to see a shift to voluntary/worksite 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/worksite market presents growth opportunities, and we will continue to develop strategies to capitalize on this expanding market.

As of December 31, 2011, we had 99 sales representatives and 107 service representatives in 31 offices. Our sales representatives accounted for 95% of our group insurance sales for the year ended December 31, 2011. 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. Results of our exited group medical insurance business are reported in this segment. For further details, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Transactions Affecting Comparability."

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 7,500 mutual funds in the U.S. as of December 31, 2010, according to the Investment Company Institute 2011 Investment Company Fact Book. The institutional asset management market has grown at a rapid pace over the last

Table of Contents

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 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. In the highly competitive U.S. insurance industry, our competitors include insurers such as Assurant, Guardian, UNUM, Lincoln Financial Group, MetLife, Sun Life, Prudential and John Hancock. 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 and Principal National Life Insurance Company ("PNLIC") have been assigned the following insurer 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 Ltd.	AA- ("Very Strong") with a stable outlook	Fourth highest of 21 rating levels
Moody's Investors Service	Aa3 ("Excellent") with a stable outlook	Fourth highest of 21 rating levels
Standard & Poor's	A ("Strong") with a positive outlook	Sixth 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 "A" ratings are assigned to those companies that have demonstrated 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. A.M. Best, Fitch, Moody's and Standard & Poor's maintain a stable outlook on the U.S. life insurance sector. However, these rating agencies note that current challenges for the industry such as global sovereign uncertainty, equity market volatility, impact of sustained low interest rates, weakness in the real estate market, lingering unemployment and weak consumer confidence are putting pressure on the stable outlook.

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

Table of Contents

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 PNLIC 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, 2011, 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.

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 the Comptroller of the Currency. Principal Bank is also a member of the Federal Deposit Insurance Corporation ("FDIC") and subject to its regulations. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), we are now supervised by the Federal Reserve Bank of Chicago ("Federal Reserve"). This oversight began in July 2011 and includes oversight of all entities within the PFG family.

Table of Contents

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 Finance 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 supporting staff 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 has its own risk committee that in most cases includes executive level corporate management and 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 volatility 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 volatility in embedded value relative to baseline embedded value under relatively adverse business and economic conditions.

Internal Capital Adequacy Ratio, which represents the relationship of actual assets to our Economic Total Asset Requirement ("ECTAR"). ECTAR signifies the total assets required to ensure that we can meet all of our obligations with a high degree of confidence and is the sum of Economic Reserves and Economic Capital.

Employees

As of December 31, 2011, we had 13,527 employees. None of our employees are subject to collective bargaining agreements governing employment with us. We believe that our employee relations are satisfactory.

Table of Contents

Internet Website

Our Internet website can be found at 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 is our code of business conduct and ethics, corporate governance guidelines and charters for the Audit, Finance, 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, uncertainty and disruption. Our results of operations, financial condition, cash flows and statutory capital position could be materially adversely affected by continued volatility, uncertainty and disruption 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 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.

Disruptions, uncertainty or volatility in the capital and credit markets may 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.

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."

Continued difficult conditions in the global capital markets and the economy generally may materially and adversely affect our business and results of operations.

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. Recently, concerns over the slow economic recovery, level of U.S. national debt and structural deficits, European sovereign debt crisis, the U.S. mortgage market, inflation levels, 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, reduced business and consumer confidence and continued high unemployment, have negatively impacted the U.S. economy. Initially, the concerns on the part of market participants were focused on the subprime segment of the mortgage-backed securities market. However, these concerns 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. Although liquidity has improved, the market for fixed income instruments has continued to experience some price volatility, credit downgrade events and elevated probabilities of default. 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 levels 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, reductions in employment levels of our existing employer customers may result in a reduction in membership levels and premium income for our specialty benefits products. Participants within the retirement plans for which we provide administrative services may elect to reduce or stop their payroll deferrals to these plans, which would reduce AUM and revenues. In addition, reductions in employment levels may result in a decline in employee deposits into retirement plans. 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 volatility or further declines 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 experienced severe declines and heightened volatility in 2008 and early 2009. Although equity markets have been recovering, equity values still remain below the values achieved in 2007. Because the revenues of our asset management and accumulation businesses 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."

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 unrealized losses in our investment portfolio and, if long-term interest rates rise dramatically within a six to twelve month time period, certain segments 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 segments 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 unrealized losses in 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 would increase unrealized losses in the investment portfolio, would increase losses associated with credit-based derivatives we have sold 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 from market volatility, which could have a material adverse effect on our results of operations or financial condition. Continuing challenges include continued weakness in the U.S. residential and commercial 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, could continue to have a material adverse effect

Table of Contents

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 maturities portfolio may reduce our profitability.

We are subject to the risk that the issuers of the fixed maturities we own will default on principal and interest payments, particularly if a major downturn in economic activity occurs. As of December 31, 2011, our U.S. investment operations held $46.7 billion of fixed maturities, or 77% of total U.S. invested assets, of which approximately 7.3% were below investment grade, including $524.4 million, or 1.12% of our total fixed maturities 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 Maturities."

Our U.S. fixed maturities portfolio includes securities collateralized by residential and commercial mortgage loans. As of December 31, 2011, our U.S. investment operations held $4.8 billion of residential mortgage-backed securities, of which $3.4 billion are Government National Mortgage Association, Federal National Mortgage Association or Federal Home Loan Mortgage Corporation pass-through securities, and $3.4 billion of commercial mortgage-backed securities, which represent in combination 17% of our total fixed maturities portfolio. For residential mortgage-backed securities, prepayment speeds, changes in mortgage delinquency or recovery rates, credit rating changes by rating agencies, change in property values underlying the loans and the quality of service provided by service providers on securities in our portfolios could lead to write-downs on these securities. For commercial mortgage-backed securities, changes in mortgage delinquency or default rates, interest rate movements, credit quality and vintage of the underlying loans, changes in property values underlying the loans and credit rating changes by rating agencies could result in write-downs of those securities. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Investments U.S. Investment Operations Fixed Maturities."

As of December 31, 2011, the international investment operations of our fully consolidated subsidiaries held $3.3 billion of fixed maturities, or 63%, of total international invested assets, of which 15% 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 maturities 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 $9.4 billion represented 14% of our total invested assets as of December 31, 2011. As of December 31, 2011, there were no loans that were in the process of foreclosure. 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, 2011, approximately $8.0 billion, or 85%, 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 maturities, commercial mortgage loans and real estate investments because they are less liquid than our publicly traded fixed maturities.

We hold certain investments that may lack liquidity, such as privately placed fixed maturities, commercial mortgage loans and real estate investments. These asset classes represented approximately 38% of the value of our invested assets as of December 31, 2011.

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, interest rate collars, swaptions, futures, currency swaps, currency forwards, credit default swaps, options and total return swaps, 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. For transactions where we are in-the-money, we are exposed to credit risk in the event of default of our counterparty. We limit our exposure to credit risk by establishing collateral agreements with nominal thresholds for a large majority of our counterparties. However, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure. With regards to our derivative exposure, we have over-collateralization requirements on the portion of collateral we hold, based on the riskiness of the assets posted as collateral. 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.

Commercial mortgage lending in the state of California accounted for 22%, or $2.1 billion, of our commercial mortgage loan portfolio as of December 31, 2011. 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 maturities and equity securities may include methodologies, estimations and assumptions which are subject to differing interpretations and could result in changes to investment valuations that may materially adversely affect our results of operations or financial condition.

Fixed maturities and equity securities reported at fair value on our consolidated statements of financial position represented the majority of our total cash and invested assets. The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three levels. The level in the fair value hierarchy 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.

Table of Contents

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.

Excluding separate account assets as of December 31, 2011, 3%, 96% and 1% 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 maturities (including public and private bonds), equity securities, over-the-counter derivatives and other investments for which public quotations are not available but that are priced by third-party pricing services or internal models using substantially all observable inputs. Our Level 3 assets and liabilities include certain fixed maturities, private equity securities, commercial mortgage loan investments and obligations of consolidated variable interest entities for which the fair value option was elected, 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 14, Fair Value Measurements."

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 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 requires estimations and assumptions which are subject to differing interpretations 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 periodic 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 instrument issuer and uses their best judgment in evaluating the cause of the decline in the estimated fair value of the instrument 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 Maturities."

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

Fixed maturities 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 maturities of $1.5 billion pre-tax as of December 31, 2011, and the component of gross unrealized losses for securities trading down 20% or more for over six months was approximately $0.7 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 Retirement and Investor Services and Principal Global Investors 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 Principal International 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 U.S. Insurance Solutions segment competes with insurers.

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.

A.M. Best, Fitch, Moody's Investors Services and Standard & Poor's 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. These rating agencies 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 and 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.

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 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. 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. Interest rates are currently at historically low levels. If interests rates were to remain low over a sustained period of time, this would put additional pressure on our spreads, potentially resulting in unlocking of our DPAC asset and increases in reserves.

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 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. For example, Mexican legislation requires that all employees contribute to a mandatory pension fund. When employees do not select a pension provider ("AFORE"), they are assigned to an AFORE by the Mexican regulator. Numerous AFOREs, including Principal AFORE, have been assigned such customers. The Mexican regulator has the ability and intent to re-assign these customers based on various investment criteria. If, and to the extent, existing customers would be reassigned, it would have a negative impact on our revenues and earnings.

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 reflecting 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 may be partially offset by our payout annuity business, where an increase in mortality rates will result in a decrease in benefit payments. Our use of third party reinsurance also helps to mitigate this risk. Our results of operations may also be adversely impacted by an increase in morbidity rates.

Our results of operations 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

Table of Contents

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 universal life-type insurance contracts, participating life insurance policies and certain investment contracts may change, impacting both the level of the asset and the timing of our net income.

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.

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, certain direct 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 administrative 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, 2011, Closed Block assets and liabilities were $4,453.6 million and $5,172.4 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.

24

Table of Contents

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 life and health 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,

Table of Contents

- 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, the U.S. 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.

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. The U.S. 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.

In addition, we benefit from certain tax items, including but not limited to, tax-exempt bond interest, dividends-received deductions, tax credits (such as foreign tax credits) and insurance reserve deductions. From time to time, the U.S. Congress, as well as foreign, state and local governments, considers legislation that could reduce or eliminate the benefits associated with these tax items. If such legislation is adopted, our profitability could be negatively impacted. We continue to evaluate the impact that potential tax reform, which lacks sufficient detail and is relatively uncertain, may have on our future results of operations and financial condition.

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

The U.S. Congress has, from time to time, considered legislation modifying the federal estate tax regime. One such piece of legislation is the Tax Reform Act of 2010, which became law on December 17, 2010. Among its many provisions were modifications to the estate tax for 2010, 2011 and 2012. These changes, while generally beneficial to taxpayers, are temporary in nature.

If these favorable estate tax modifications are continued beyond 2012, or if the federal estate tax is repealed, then potentially there could be some level of contraction in the estate planning market. It is possible that some segment of this existing business would be terminated or sold to investor groups. On the other hand, a portion of this coverage would likely be retained to pay other expenses associated with death such as state estate/inheritance taxes, capital gains taxes, or income taxes.

We currently have approximately $32.7 billion of estate tax-related life insurance from nearly 20,700 policies in force as of December 31, 2011. This block of policies accounts for approximately $290.0 million of annual recurring life insurance premium and also represents over $1.9 billion of policy cash value.

Based on an average of the last three years of estimated new sales of estate-tax related products, we have issued approximately 1,700 policies annually, representing $34.5 million of annual premium and nearly $4.9 billion of life insurance coverage.

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.

Financial services regulatory reform may reduce our profitability, impact how we do business or limit our ability to engage in certain capital expenditures.

On July 21, 2010, the Dodd-Frank Act was enacted and signed into law. The Dodd-Frank Act makes extensive changes to the laws regulating financial services firms and requires various federal agencies to adopt a broad range of new implementation rules and regulations. The federal agencies were given significant discretion in drafting the implementation rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act will not be known for many months or years. In addition, the legislation mandates multiple studies and reports for Congress, which could result in additional legislative or regulatory action.

In July 2011, we became subject to oversight from the Federal Reserve including various capital and liquidity requirements due to our wholly-owned Savings & Loan subsidiary. It is possible that we could be labeled as "Systemically Important" by the Financial Stability Oversight Council which brings with it even more oversight and prudential standards from the Federal Reserve. While the initial regulations indicate that we will not fall within the definition of a "Major Swap Participant" ("MSP"), it is possible that change in the final rules could alter this interpretation. Designation as an MSP will result in more oversight of derivative transactions under the separate jurisdictions of the SEC and the Commodities Futures Trading Commission. This includes swaps traded through either regulated exchanges or approved clearinghouses, and require additional collateral to support derivatives transactions.

In addition, we are subject to minimum capital requirements as a result of this regulatory oversight and those requirements may change based on future legislation and/or the adoption of Basel III capital requirements by the U.S. These minimum capital requirements and the qualitative oversight of the Federal Reserve may limit our ability to pay stockholder dividends, conduct a merger or acquisition, or engage in other activities, including share repurchases.

The changes resulting from the Dodd-Frank Act and the yet to be finalized implementation rules and regulations may lower the profitability of our business activities, require changes to certain of our business practices or otherwise adversely affect our business.

Changes in accounting standards may adversely impact our reported profitability and financial ratios.

Accounting standards are subject to change and can negatively impact our reported 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 U.S. and international standard setters have a full agenda of topics they plan to review, any of which have the potential to negatively impact our reported profitability and financial ratios. The results for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period.

We may be unable to mitigate the impact of Regulation XXX and Actuarial Guideline 38, potentially resulting in a negative impact to our capital position and/or a reduction in sales of term and universal life insurance products.

The NAIC Model Regulation entitled "Valuation of Life Insurance Policies," commonly known as "Regulation XXX", establishes statutory reserve requirements for term life insurance policies and universal life insurance policies with secondary guarantees. Actuarial Guideline 38 ("AG38") clarifies the application of Regulation XXX with respect to certain universal life insurance products with secondary guarantees. The application of Regulation XXX and AG38 involve numerous interpretations. It is possible that our interpretation of these and other actuarial guidelines and regulations may differ from the interpretations of state regulators. Such differences of interpretation may lead to us having to increase the statutory reserves that we hold for certain products.

In addition, we have implemented reinsurance and capital management actions to mitigate the capital impact of Regulation XXX and AG38 on our term and universal life insurance business. We cannot provide assurance that we will be able to continue to implement these actions for future sales of term and universal life insurance business. If we are unable to mitigate the impact of Regulation XXX and AG38 on future sales, additional capital will be required to support those sales, and we may be required to increase prices and/or reduce sales of our term and universal life insurance products.

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.

Table of Contents

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 business operations. We are, from time to time, also involved in various governmental, regulatory and administrative proceedings and inquiries.

We have received regulatory inquiries from certain state insurance regulators and other officials relating to compliance with unclaimed property laws and the use of data available on the U.S. Social Security Administration's Death Master File (or a similar database) to identify instances where benefits under life insurance policies, annuities and retained asset accounts are payable. It is possible that other jurisdictions may pursue similar inquiries and that such inquiries may result in payments to beneficiaries, escheatment of funds deemed abandoned under state laws and changes to procedures for the identification and escheatment of abandoned property.

These factors may affect our financial strength or reduce our profitability. For further discussion on litigation and regulatory investigation risk, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 12, Contingencies, Guarantees and Indemnifications" under the caption, "Litigation and Regulatory Contingencies."

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. The final determination of any tax audit, appeal of the decision of a taxing authority, tax litigation or similar proceedings may 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."

Applicable laws and our certificate of incorporation and by-laws may discourage takeovers and business combinations that some 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 some 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 some 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

Table of Contents

- 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 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 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 insurance businesses. However, the risk of increased mortality on our life insurance business may be 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, 2011, we own 26 properties in our home office complex in Des Moines, Iowa, and in various other locations. Of these 26 properties, 12 are office buildings, 1 is a warehouse facility, 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 92% of the 2.7 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. 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 12, Contingencies, Guarantees and Indemnifications" under the caption, "Litigation and Regulatory Contingencies" and Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 10, Income Taxes" under the caption, "Other Tax Information," which are incorporated here by this reference.

Table of Contents

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.

Gregory B. Elming, 51, has been Senior Vice President and Chief Risk Officer of the Company and Principal Life since March 2011. Prior to that time, he was Senior Vice President and Controller of the Company and Principal Life since 2007 and Vice President and Controller of the Company and Principal Life since 2002.

Daniel J. Houston, 50, who heads the Retirement and Investor Services and U.S. Insurance Solutions segments of our operations, was named President, Retirement, Insurance and Financial Services of the Company and Principal Life on January 1, 2010. He was President, Retirement and Investor Services, from February 2008 until January 2010, and was Executive Vice President, Retirement and Investor Services, from June 2006 to February 2008.

Julia M. Lawler, 52, has been Senior Vice President and Chief Investment Officer of the Company and of Principal Life since July 2002. From 2000 to 2002, she was President of the Real Estate Equity Group of Principal Global Investors, LLC.

Terrance J. Lillis, 59, 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, 58, who heads the Principal Global Investors segment of our operations, has been President, Principal Global Investors 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 to 2002, he was Chief Executive Officer of the Americas division of Credit Suisse Asset Management in New York, New York.

Mary A. O'Keefe, 55, who heads Corporate Relations, 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, 54, has been Senior Vice President and Chief Information Officer of the Company and Principal Life since November 2002. From 1998 to 2002, he was Vice President of retail information services of Principal Life.

Karen E. Shaff, 57, 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, 66, chairman of Principal International, heads the Principal International segment of our operations. Prior to his current position, he has been President and Chief Executive Officer of Principal International, Inc. since 1998 and served as President, Principal International, of the Company and Principal Life since 2010; Executive Vice President, Principal International, of the Company and Principal Life since February 2008; Senior Vice President, Principal International of the Company, since April 2001; and Senior Vice President of Principal Life since December 1998. Mr. Sorensen has announced his retirement from the Company effective February 29, 2012, and Luis Valdes, President Principal International, will head the Principal International segment of our operations as part of a planned succession.

Larry D. Zimpleman, 60, has been a Director of the Company and Principal Life since 2006. He has been Chairman, President and Chief Executive Officer of the Company and Principal Life since May 2009 and was President and Chief Executive Officer of the Company and Principal Life from May 2008 to May 2009. Prior thereto, he 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.

Table of Contents

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 8, 2012, there were 404,343 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
2011			
First quarter	**$ 34.70**	**$ 30.28**	
Second quarter	**$ 35.00**	**$ 27.81**	
Third quarter	**$ 31.00**	**$ 21.55**	
Fourth quarter	**$ 28.76**	**$ 20.48**	**$ 0.70**
2010			
First quarter	$ 29.61	$ 20.89	
Second quarter	$ 31.41	$ 23.33	
Third quarter	$ 26.64	$ 21.19	
Fourth quarter	$ 33.34	$ 25.42	$ 0.55

We declared an annual cash dividend of $0.70 per common share on October 26, 2011, and paid such dividend on December 2, 2011, to stockholders of record on the close of business on November 10, 2011. We declared an annual cash dividend of $0.55 per common share on November 1, 2010, and paid such dividend on December 3, 2010, to stockholders of record on the close of business on November 19, 2010. 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)
January 1, 2011 January 31, 2011	**931**	**$ 25.76**		**$ 250.0**
February 1, 2011 February 28, 2011	**412**	**$ 32.77**		**$ 250.0**
March 1, 2011 March 31, 2011	**175,259**	**$ 33.82**		**$ 250.0**
April 1, 2011 April 30, 2011	**521**	**$ 32.39**		**$ 250.0**
May 1, 2011 May 31, 2011	**1,615,674**	**$ 31.41**	**1,609,108**	**$ 199.5(2)**
June 1, 2011 June 30, 2011	**6,085,457**	**$ 29.50**	**6,083,184**	**$ 20.0(2)**
July 1, 2011 July 31, 2011	**682,254**	**$ 29.33**	**682,024**	**$ (2)**
August 1, 2011 August 31, 2011	**2,544,606**	**$ 22.99**	**2,538,500**	**$ 141.7(3)**
September 1, 2011 September 30, 2011	**5,885,026**	**$ 24.07**	**5,884,461**	**$ (3)**
October 1, 2011 October 31, 2011	**234**	**$ 23.72**		**$**
November 1, 2011 November 30, 2011	**963**	**$ 24.41**		**$ 100.0(4)**
December 1, 2011 December 31, 2011	**4,131,450**	**$ 24.20**	**4,131,450**	**$ (4)**
Total	**21,122,787**		**20,928,727**	

(1) Includes the number of shares of common stock utilized to execute certain stock incentive awards and shares purchased as part of a publicly announced program.

(2) During May 2011, our Board of Directors reinstated the November 2007 share repurchase program, which had previously been suspended. This program was completed in July 2011.

(3) During August 2011, our Board of Directors authorized a repurchase program of up to $200.0 million of our outstanding common stock. This program was completed in September 2011.

(4) During November 2011, our Board of Directors authorized a repurchase program of up to $100.0 million of our outstanding common stock. This program was completed in December 2011.

Table of Contents

Item 6. Selected Financial Data

The following table sets forth certain selected historical consolidated financial information. We derived the consolidated financial information (except for amounts referred to as "Other Supplemental Data") for each of the years ended December 31, 2011, 2010 and 2009 and as of December 31, 2011 and 2010 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, 2008 and 2007 and as of December 31, 2009, 2008 and 2007 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,				
	2011 (1)	**2010 (1)**	**2009 (1)**	**2008**	**2007**
	($ in millions, except per share data and as noted)				
Income Statement Data:					
Revenues:					
Premiums and other considerations	**$ 2,891.0**	$ 3,555.5	$ 3,750.6	$ 4,209.2	$ 4,634.1
Fees and other revenues	**2,565.1**	2,298.1	2,096.0	2,426.5	2,634.7
Net investment income	**3,375.8**	3,496.5	3,400.8	3,994.3	3,966.5
Net realized capital losses	**(122.3)**	(191.5)	(398.3)	(694.1)	(328.8)
Total revenues	**$ 8,709.6**	$ 9,158.6	$ 8,849.1	$ 9,935.9	$ 10,906.5
Income from continuing operations, net of related income taxes	**$ 751.2**	$ 717.2	$ 645.7	$ 465.8	$ 864.3
Net income	**$ 751.2**	$ 717.2	$ 645.7	$ 465.8	$ 884.5
Earnings per Common Share Data:					
Income from continuing operations, net of related income taxes, per share:					
Basic	**$ 2.17**	$ 2.08	$ 1.98	$ 1.64	$ 3.04
Diluted	**$ 2.15**	$ 2.06	$ 1.97	$ 1.63	$ 3.01
Net income per share:					
Basic	**$ 2.17**	$ 2.08	$ 1.98	$ 1.64	$ 3.12
Diluted	**$ 2.15**	$ 2.06	$ 1.97	$ 1.63	$ 3.09
Cash dividends per common share	**$ 0.70**	$ 0.55	$ 0.50	$ 0.45	$ 0.90
Balance Sheet Data:					
Total assets	**$ 148,298.0**	$ 145,631.1	$ 137,759.4	$ 128,182.4	$ 154,520.2
Long-term debt	**$ 1,564.8**	$ 1,583.7	$ 1,584.6	$ 1,290.5	$ 1,398.8
Series A preferred stock	**$**	$	$	$	$
Series B preferred stock	**0.1**	0.1	0.1	0.1	0.1
Total stockholders' equity	**10,013.0**	9,885.0	8,016.4	2,569.3	7,519.3
Other Supplemental Data:					
AUM ($ in billions)	**$ 335.0**	$ 318.8	$ 284.7	$ 247.0	$ 311.1

(1) For a discussion of items materially affecting the comparability of 2011, 2010 and 2009, please see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Transactions Affecting Comparability of Results of Operations."

Table of Contents

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, 2011, compared with December 31, 2010, and our consolidated results of operations for the years ended December 31, 2011, 2010 and 2009, 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:

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

- Principal Global Investors, which consists of our asset management operations, manages assets for sophisticated investors around the world, using a multi-boutique strategy that enables the segment to provide an expanded range of diverse investment capabilities including equity, fixed income and real estate investments. Principal Global Investors also has experience in currency management, asset allocation, stable value management and other structured investment strategies.

- Principal International, which offers retirement products and services, annuities, mutual funds, institutional asset management and life insurance accumulation products through operations in Brazil, Chile, China, Hong Kong SAR, India, Mexico and Southeast Asia.

- U.S. Insurance Solutions, which provides individual life insurance as well as specialty benefits in the U.S. Our individual life insurance products include universal and variable universal life insurance and traditional life insurance. Our specialty benefit products include group dental and vision insurance, individual and group disability insurance and group life insurance. Effective January 1, 2011, wellness services and fee-for-service claims administration transitioned to the Specialty Benefits division from the Corporate segment.

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

Economic Factors and Trends

Continuing improvement in the equity markets since the latter half of 2009 led to increases in our Retirement and Investor Services segment's account values and our Principal Global Investors segment's AUM relative to year-end 2008. Since account values and AUM are the base by which these businesses generate profits, the increase in account values and AUM has contributed to the overall improvement of our profits.

In our Principal International segment, we continued to grow our business organically through our existing subsidiaries and joint ventures and through strategic acquisitions. Local currency AUM, a key indicator of earnings growth for the segment, increased significantly as a result of positive net customer cash flows and market performance. The financial results for the Principal International segment are also impacted by fluctuations of the foreign currency to U.S. dollar exchange rates for the countries in which we have business.

In our U.S. Insurance Solutions segment, we continue to shift the marketing emphasis of our individual life insurance business to universal life insurance products from traditional life insurance products. Our specialty benefits insurance division experienced a slowdown in growth of group products between 2009 and 2010 relative to prior years due

Table of Contents

to a combination of lower sales, higher lapses, reduced growth in salaries and reductions in covered lives of our existing group customers as a result of economic pressure. In 2011, we saw signs of recovery through higher sales, slight inforce membership growth and improved retention.

Profitability

Our profitability depends in large part upon our:

- amount of AUM;
- spreads we earn on our general account asset accumulation business that result from the difference between what we earn and what we credit to policyholders;
- ability to generate fee revenues by providing administrative and investment management services;
- ability to price our 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. Fixed maturities include bonds, redeemable preferred stock and certain non-redeemable preferred stock. We classify our fixed maturities 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 maturities are primarily based on market prices from independent pricing services. We have regular interactions with these vendors to ensure we understand their pricing methodologies and to confirm they are utilizing observable market information. In addition, 22% of our invested asset portfolio is invested in fixed maturities that are private placement 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 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. See item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 14, Fair Value Measurements" for further discussion.

If we are unable to price a fixed maturity security from third party pricing vendors we may obtain a broker quote or utilize an internal pricing model specific to the asset utilizing relevant market information to the extent available. Less than 1% of our fixed maturities were valued using internal models.

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 $40.3 billion, as compared to the recorded amount of $42.2 billion related to our fixed maturity, available-for-sale assets held by the Principal Life general account as of December 31, 2011. Given the recent unprecedented market disruption, a 100 basis point movement in the combined portfolio rate is reasonably likely.

We had a $741.5 million increase in net unrealized gains within the U.S. fixed maturities, available-for-sale portfolio for the year ended December 31, 2011, of which an approximate $2.2 billion net unrealized gain can be attributed to an approximate 98 basis points decrease in interest rates offset in part by net unrealized losses related to other market factors. We had a $2,154.6 million increase in net unrealized gains for the year ended December 31, 2010, of which an approximate $1.0 billion net unrealized gain can be attributed to an approximate 57 basis points decrease in interest rates and the remaining net unrealized gains related to other market factors.

Fixed maturities classified as available-for-sale are subject to impairment reviews. When evaluating fixed maturities 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; (4) for structured securities, the adequacy of the expected cash flows and (5) our intent to sell a security or whether it is more likely than not we will be required to sell the security before recovery of its amortized cost which, in some cases, may extend to maturity. 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, and a corresponding impairment loss is reported primarily in net income, with noncredit impairment losses for certain fixed maturities we do not intend to sell reported in other comprehensive 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, 2011, we had $9,052.3 million in available-for-sale fixed maturities with gross unrealized losses totaling $1,523.9 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 $1,523.9 million, on a pre-tax basis, if all the securities in an unrealized loss position were deemed to be other than temporarily impaired and our intent was to sell all such securities.

Mortgage Loans. Mortgage loans consist primarily of commercial mortgage loans. At December 31, 2011, the carrying value of our commercial mortgage loans was $9,396.6 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 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 created for the difference between the carrying amount of the mortgage loan and the estimated value less cost to sell. Estimated value is based on either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the 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 requires estimating the amounts and timing of future cash flows expected to be received on specific loans, estimating the value of the collateral and gauging 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. For more detailed information concerning mortgage loan valuation allowances and impairments, see "Investments U.S. Investment Operations Mortgage Loans," and Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 4, Investments Mortgage Loan Valuation Allowance."

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 mid 40% percent loan-to-value range at origination with a net operating income coverage ratio of 3.3 times the annual debt service and is internally rated AA- on a bond equivalent basis. Based on the most recent analysis, our commercial mortgage loan portfolio, excluding mortgage loans held in our Principal Global Investors segment, has an overall loan-to-value ratio of 60% with a 2.0 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 exchange-traded derivatives are determined through quoted market prices. The fair values of over-the-counter derivative instruments are determined using either pricing valuation models that utilize market observable inputs or broker quotes. On an absolute fair value basis, 91.2% of our over-the-counter derivative assets and liabilities are valued using pricing valuation models, while the remaining 8.8% are valued using broker quotes. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 14, Fair Value Measurements" for further discussion. The fair values

35

Table of Contents

of our derivative instruments can be impacted by changes in interest rates, foreign exchange rates, credit spreads, equity indices, and volatility, as well as other contributing factors.

We also issue certain annuity contracts and other insurance contracts that include embedded derivatives that have been bifurcated from the host contract. They are valued using a combination of historical data and actuarial judgment. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 14, Fair Value Measurements" for further discussion. We include our assumption for own non-performance risk in the valuation of these embedded derivatives. As our credit spreads widen or tighten, the fair value of the embedded derivative liabilities decrease or increase, leading to an increase or decrease in net income. If the current market credit spreads reflecting our own creditworthiness move to zero (tighten), the reduction to net income would be approximately $21.6 million, net of DPAC and income taxes, based on December 31, 2011, reported amounts. The use of risk margins for the valuation of embedded derivatives increases the fair value of the embedded derivative liabilities.

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 ("EGP"). In addition to DPAC, the following actuarial balances are also amortized in relation to EGP 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 EGP.

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 EGP.

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 EGP 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 for universal life-type insurance contracts, participating life insurance policies and certain investment contracts is amortized over the expected life of the contracts acquired, in proportion to EGP.

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 that contains 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 if actual experience or other evidence suggests that earlier estimates should be revised. 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 EGP. If actual annualized U.S. equity market performance varies from our 8% long-term assumption, we assume different performance levels in the short term 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, and the mean reversion rate has remained at the 12% cap since then. Therefore, until the mean reversion rate falls below the 12% cap, we will not adjust the equity return assumption by the amount needed to result in a mean return equal to the long-term assumption.

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

Table of Contents

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, 2011, these policies accounted for 12% of our total DPAC balance.

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, 2011, the net balance of DPAC and related actuarial balances, excluding balances affected by changes in other comprehensive income, was a $3,452.4 million asset. We perform sensitivity analyses to assess the impact that certain assumptions have on our DPAC and related actuarial balances. The Financial Accounting Standards Board ("FASB") issued authoritative guidance that will be effective for us on January 1, 2012, which modifies the definition of the types of costs incurred by insurance entities that can be capitalized in the successful acquisition of new or renewal insurance contracts. Our retrospective adoption of this guidance will result in a reduction to our DPAC asset. As a result, we do not believe sensitivities related to our December 31, 2011, balances provide meaningful information. We will perform sensitivity analyses to estimate the impact of various assumption changes on our DPAC and related actuarial balances as of March 31, 2012.

Goodwill and Other Intangible Assets

Goodwill and other intangible assets 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, we test the carrying value for impairment at least annually at the reporting unit level, which is a business one level below the operating segment. We formally conduct our annual goodwill and other intangible asset impairment testing during the fourth quarter. Under certain circumstances, interim impairment tests may be required if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 1, Nature of Operations and Significant Accounting Policies" for further discussion.

We are required to perform a two-step test in our evaluation of the carrying value of goodwill. In Step 1 of the evaluation, the fair value of each reporting unit is determined and compared to the carrying value of the reporting unit. If the fair value is greater than the carrying value, then the carrying value of the reporting unit is deemed to be recoverable, and Step 2 is not required. If the fair value estimate is less than the carrying value, it is an indicator that impairment may exist, and Step 2 is required. In Step 2, the reporting unit's goodwill implied fair value is determined. The reporting unit's fair value as determined in Step 1 is assigned to all of its net assets (recognized and unrecognized) as if the reporting unit were acquired in a business combination as of the date of the impairment test. If the implied fair value of the reporting unit's goodwill is lower than its carrying amount, goodwill is impaired and written down to its implied fair value.

The determination of fair value for our reporting units is primarily based on an income approach whereby we use discounted cash flows for each reporting unit. When available, and as appropriate, we use market approaches or other valuation techniques to corroborate discounted cash flow results. The discounted cash flow model used for each reporting unit is based on either income or distributable cash flow, depending on the reporting unit being valued.

For the income model, we determine fair value based on the present value of the most recent income projections for each reporting unit and calculate a terminal value utilizing a terminal growth rate. The significant assumptions in the operating income model include: income projections, including the underlying assumptions; discount rate and terminal growth rate.

For the distributable cash flow model, we determine fair value based on the present value of projected statutory net income and changes in required capital to determine distributable income for the respective reporting unit. The significant assumptions in the distributable cash flow model include: required capital levels; income projections, including the underlying assumptions; discount rate; new business projection period and new business production growth.

Intangible assets with useful 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 assets amortized as related benefits emerge, the most significant assumptions involved in the estimation of future benefits include surrender/lapse rates, interest margins and mortality.

We did not recognize a material impairment in our 2011 consolidated statement of operations. Investment management contracts acquired in our 2006 purchase of WM Advisors, Inc. are considered an indefinite lived intangible and are the most material intangible asset included in our 2011 consolidated statement of financial position with a carrying value of $608.0 million. Positive net cash flows and expected future flows combined with 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, 2011, was in excess of its carrying value. We cannot predict certain future events that might adversely affect the reported value of goodwill and other intangible assets that totaled $482.3 million and $890.6 million, respectively, as of December 31, 2011. 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, 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 2, 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 individual traditional 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 have been 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 expense.

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 for high quality corporate bonds. Our assumed discount rate for the 2011 year-end was 5.15%. A 0.25% decrease in the discount rate would increase the pension benefits Projected Benefit Obligation and the 2012 Net Periodic Pension Cost ("NPPC") by approximately $79.9 million and $11.8 million, respectively. A 0.25% decrease in the discount rate would increase the other postretirement benefits Accumulated Postretirement Benefit Obligation by approximately $3.8 million and would have a nominal impact on the 2012 Net Periodic Benefit Cost ("NPBC"). 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 real risk free 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 2011

NPPC and 2011 NPBC, an 8.00% and 7.30% weighted average long-term rate of return was used, respectively. For the 2012

Table of Contents

NPPC and 2012 NPBC, an 8.00% and 7.30% weighted average long-term rate of return assumption, respectively, will also be used. A 0.25% decrease in the assumed long-term rate of return would increase 2012 NPPC by approximately $3.6 million and the 2012 NPBC by approximately $1.2 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, 2011.

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 7 years for pension costs and approximately 11 years for other postretirement benefit costs. Prior service costs are amortized on a weighted average basis over approximately 3 years for pension and 4 years for other postretirement benefit costs. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 11, Employee and Agent Benefits" for further discussion.

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 income tax rate in a particular quarter or annual period. Deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates expected to be in effect during the years in which the basis differences reverse. We are required to evaluate the recoverability of our deferred tax assets each quarter and establish a valuation allowance, if necessary, to reduce our deferred tax assets to an amount that is more-likely-than-not to be realizable. In determining the need for a valuation allowance, we consider many factors, including future reversals of existing taxable temporary differences, future taxable income exclusive of reversing temporary differences and carryforwards, taxable income in prior carryback years and implementation of any feasible and prudent tax planning strategies management would employ to realize the tax benefit.

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 operating losses, capital losses and certain tax credits. In the event these estimates differ from our 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 U.S. as well as various state and foreign 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 Internal Revenue Service or other income taxing authorities for audits ongoing or not yet commenced.

We had $263.2 million and $230.9 million of current income tax receivables associated with outstanding audit issues reported as other assets in our consolidated statements of financial position as of December 31, 2011 and 2010, 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 entered into acquisition agreements or acquired the following businesses, among others, during the past three years:

Origin Asset Management LLP. On October 3, 2011, we finalized the purchase of a 74% interest in Origin Asset Management LLP ("Origin"), a global equity specialist based in London. The initial payment was $63.6 million. Origin had $2.6 billion in AUM in global and international equities at the time of the acquisition and is consolidated within the Principal Global Investors segment.

HSBC AFORE, S.A. de C.V. On August 8, 2011, we finalized the purchase of our 100% interest in HSBC AFORE, S.A. de C.V. ("HSBC AFORE"), a Mexican pension business, from HSBC Bank for $206.1 million. In addition, we and HSBC Bank have agreed to establish a distribution arrangement for the distribution of Principal AFORE's products through HSBC Bank's extensive network in Mexico. HSBC AFORE is consolidated within the Principal International segment.

Finisterre Capital LLP and Finisterre Holdings Limited. On July 1, 2011, we finalized the purchase of a 51% interest in Finisterre Capital LLP and Finisterre Holdings Limited, (together "Finisterre Capital"), an emerging markets debt investor based in London. The initial payment was $84.6 million, with a possible additional contingent payment of up to

Table of Contents

$30.0 million in 2013, dependent upon performance targets. Finisterre Capital had $1.7 billion in AUM at the time of acquisition and is accounted for on the equity method within the Principal Global Investors segment.

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 fixed income asset management contracts within our Post Advisory Group, LLC subsidiary, at which time we realized benefits from the cancellation of deferred compensation agreements. The AUM associated with this sale totaled $3.8 billion. The total cash proceeds totaled $48.4 million and were received over a three year time period.

The transaction does not qualify for discontinued operations treatment under U.S. GAAP. The realized capital gain from the sale, which is reflected in our Principal Global Investors segment, is not material.

Other

Individual Life Insurance Model and Assumption Changes. During the second quarter of 2011, our individual life insurance business made routine model and assumption changes (collectively referred to as "integrated model changes") that resulted in a net loss of $3.9 million after-tax for the second quarter. The integrated model changes altered the future estimated gross profit patterns that impact actuarial balances associated with our universal life and variable universal life insurance products. These balances are all part of an integrated model and, therefore, although the impact to earnings was not material, the integrated model changes created volatility within certain income statement line items that are impacted by the same future estimated gross profit patterns. Specifically, fee revenues increased $48.5 million; benefits, claims and settlement expenses decreased $131.1 million; and operating expenses increased $185.6 million due to the unlocking of actuarial balances resulting from the integrated model changes.

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

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

With the exception of corporate overhead, amounts related to our group medical insurance business previously included in segment operating earnings have been removed from operating earnings for all periods presented and are reported as other after-tax adjustments. The operating revenues associated with our exited group medical insurance business were $606.3 million, $1,403.9 million and $1,610.6 million for the years ended December 31, 2011, 2010 and 2009, respectively. The other after-tax adjustments associated with the after-tax earnings of our exited group medical insurance business were $50.9 million, $24.0 million and $70.5 million for the years ended December 31, 2011, 2010 and 2009, respectively.

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

Senior Note Issuance. On May 18, 2009, we issued $750.0 million of senior notes. We issued a $400.0 million series of notes that bear interest at 7.875% and will mature on May 15, 2014, and a $350.0 million series of notes that bear interest at 8.875% and will mature on May 15, 2019. Interest on the notes is payable semi-annually on May 15 and November 15 each year, beginning on November 15, 2009. The proceeds were primarily used to refinance $440.9 million of notes that matured on August 15, 2009, with the remaining proceeds being used for general corporate purposes.

Common Stock Issuance. On May 11, 2009, we issued 58.2 million shares of common stock at a price of $19.75 per share. Net proceeds from the issuance were $1,109.1 million. The proceeds from this offering were used for 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 financial results. The Principal International segment's operating earnings were positively impacted by $7.1 million, positively impacted by $15.2 million and negatively impacted by $19.6 million for the years ended December 31, 2011, 2010 and 2009, 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."

Effects of Inflation

The impact of inflation has not had a material effect on our annual consolidated results of operations over the past three years. However, we may be materially affected by inflation in the future. For further discussion on inflation, see Item 1A. "Risk Factors Continued difficult conditions in the global capital markets and the economy generally may materially and adversely affect our business and results of operations."

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 17, Stock-Based Compensation Plans."

Employee and Agent Benefits Expense

The 2011 annual defined benefit pension expense for substantially all of our employees and certain agents was $92.7 million pre-tax, which was a $16.8 million decrease from the 2010 pre-tax pension expense of $109.5 million. This decrease is primarily due to actual asset returns in 2010 that were greater than expected. The higher asset value increased the expected return on plan assets in 2011 and the actuarial gain reduced the previous actuarial loss and its amortization in 2011. The expected long-term return on plan assets used to develop the 2011 expense remained at the same 8.0%. The original discount rate used to develop the 2011 expense was 5.65%. During 2011, the Home Office Pension Plan was remeasured quarterly and expense redetermined using a discount rate of 5.80% as of March 31, 2011, 5.70% as of June 30, 2011 and 5.25% as of September 30, 2011. Asset and liability performance as of each measurement date affected the expense in the following quarter. We will not be remeasuring the Home Office Pension Plan quarterly in 2012.

The 2012 annual defined benefit pension expense for substantially all of our employees and certain agents is expected to be $122.1 million pre-tax, which is a $29.4 million increase from the 2011 pre-tax pension expense of $92.7 million. This increase is primarily due to a decrease in the discount rates as of December 31, 2011, increasing the service cost, interest cost, and gain/loss amortization. The expected long-term return on plan assets used to develop the 2012 expense remained at the same 8.0%. The discount rate used to develop the 2012 expense was 5.15%, down from the various discount rates used in 2011.

The 2011 annual other postretirement employee benefit ("OPEB") plan expense (income) for retired employees was $(58.0) million pre-tax, which is a $(46.7) million difference from the 2010 pre-tax OPEB income of $(11.3) million. This difference is primarily due to significant changes in plan design for the postretirement medical plan. For retirements on or after January 1, 2011, the company-paid subsidy for pre-Medicare-eligible coverage is 40% and the cost of coverage for Medicare-eligible retirees (or their dependents) is no longer subsidized. In addition to the changes for individuals retiring on or after January 1, 2011, the method for determining the premium equivalent rate was changed to be solely based on retiree experience. The expected long-term return on plan assets used to develop the expense (income) in 2011 remained at 7.30%, which was used to develop the 2010 expense. The original discount rate used to develop the 2011 expense (income) was 5.65%. During 2011, the Home Office Health and Life Plans were remeasured quarterly using a discount rate of 5.80% as of March 31, 2011, 5.70% as of June 30, 2011 and 5.25% as of September 30, 2011.

The 2012 annual OPEB plan expense (income) for retired employees is expected to be $(55.9) million pre-tax, which is a $2.1 million difference from the 2011 pre-tax OPEB income of $(58.0) million. This difference is primarily due to a reduction in the prior service credit to be recognized. The 2011 expense included $(5.1) million in one-time credits due to the curtailment from the health insurance business exit. The expected long-term return on plan assets used to develop the expense (income) in 2012 remained at 7.30%, which was used to develop the 2011 expense. The discount rate used to develop the 2012 expense (income) decreased to 5.15%, down from the various discount rates used in 2011.

Healthcare Reform

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

Table of Contents

Recent Accounting Changes

In October 2010, the FASB issued authoritative guidance that modifies the definition of the types of costs incurred by insurance entities that can be capitalized in the successful acquisition of new or renewal insurance contracts. Capitalized costs should include incremental direct costs of contract acquisition, as well as certain costs related directly to acquisition activities such as underwriting, policy issuance and processing, medical and inspection and sales force contract selling. This guidance will be effective for us on January 1, 2012, and we will adopt this guidance on a retrospective basis.

Our retrospective adoption of this guidance will result in a reduction in our DPAC asset as well as a decrease in amortization associated with those previously deferred costs. There will also be a reduction in the level of costs we defer subsequent to adoption. Our retrospective adoption will result in a reduction to the opening balance of retained earnings of approximately $640.0 million at January 1, 2012. This amount does not include the impact of net unrealized gains (losses) on available-for-sale securities. We currently estimate that net income available to common stockholders and operating earnings will decrease between $35.0 million and $45.0 million for the year ended December 31, 2012. These estimates are based on our current operating assumptions and are subject to change.

For other 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)	
	2011	**2010**	**2009**	**2011 vs. 2010**	**2010 vs. 2009**
			(in millions)		
Revenues:					
Premiums and other considerations	**$ 2,891.0**	$ 3,555.5	$ 3,750.6	$ (664.5)	$ (195.1)
Fees and other revenues	**2,565.1**	2,298.1	2,096.0	267.0	202.1
Net investment income	**3,375.8**	3,496.5	3,400.8	(120.7)	95.7
Net realized capital gains, excluding impairment losses on available-for-sale securities	**75.0**	48.7	54.9	26.3	(6.2)
Total other-than-temporary impairment losses on available-for-sale securities	**(147.6)**	(296.3)	(714.1)	148.7	417.8
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income	**(49.7)**	56.1	260.9	(105.8)	(204.8)
Net impairment losses on available-for-sale securities	**(197.3)**	(240.2)	(453.2)	42.9	213.0
Net realized capital losses	**(122.3)**	(191.5)	(398.3)	69.2	206.8
Total revenues	**8,709.6**	9,158.6	8,849.1	(449.0)	309.5
Expenses:					
Benefits, claims and settlement expenses	**4,454.1**	5,338.4	5,334.5	(884.3)	3.9
Dividends to policyholders	**210.2**	219.9	242.2	(9.7)	(22.3)
Operating expenses	**3,057.7**	2,759.0	2,526.6	298.7	232.4
Total expenses	**7,722.0**	8,317.3	8,103.3	(595.3)	214.0
Income before income taxes	**987.6**	841.3	745.8	146.3	95.5
Income taxes	**236.4**	124.1	100.1	112.3	24.0
Net income	**751.2**	717.2	645.7	34.0	71.5
Net income attributable to noncontrolling interest	**36.2**	17.9	23.0	18.3	(5.1)
Net income attributable to Principal Financial Group, Inc.	**715.0**	699.3	622.7	15.7	76.6
Preferred stock dividends	**33.0**	33.0	33.0		

Net income available to common stockholders	**$ 682.0**	$ 666.3	$ 589.7	$ 15.7	$ 76.6

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Net Income Available to Common Stockholders

Net income available to common stockholders increased primarily due to a realized capital gain associated with the sale of a portion of our interest in Catalyst Health Solutions, Inc. in 2011, lower net impairment losses on fixed maturities, available-for-sale and higher earnings in our U.S. Insurance Solutions, Principal International and Principal Global Investors segments. These increases to net income available to common stockholders were partially offset by the impact of a court ruling on some uncertain tax positions.

Total Revenues

Premiums decreased $770.3 million for the Corporate segment primarily due to a reduction in average covered medical members in our exited group medical insurance business.

Table of Contents

Fees increased $148.9 million for our U.S. Insurance Solutions segment primarily due to growth in the universal life and variable universal life lines of business and the unlocking of unearned revenue associated with integrated model changes. Fees also increased $73.2 million for our Retirement and Investor Services segment primarily due to higher fees stemming from an increase in average account values, which resulted from generally positive equity market performance since 2010. In addition, fees increased $64.0 million for our Principal Global Investors segment primarily due to higher fee revenues driven by an increase in average AUM as well as increased performance fees in our equity business and higher borrower fees from our real estate business.

Net investment income decreased due to lower yields and a decrease in average invested assets and cash, excluding the fair value adjustment associated with fixed maturities and equity securities, primarily due to our decision to scale back our investment only business. These decreases were partially offset by higher inflation-based investment returns on average invested assets and cash as a result of higher inflation in Chile and the strengthening of the Latin American currencies against the U.S. dollar. For additional information, see "Investments Investment Results."

Net realized capital gains (losses) can be volatile due to other than temporary impairments of invested assets, mark-to-market adjustments of certain invested assets and our decision to sell invested assets. Net realized capital losses decreased primarily due to a gain associated with the sale of a portion of our interest in Catalyst Health Solutions, Inc. in 2011, lower losses related to the residential mortgage loan loss provision for our Bank and Trust Services business and lower net impairment losses on fixed maturities, available-for-sale. These decreases were partially offset by a 2010 gain associated with the signing of our Shareholders Agreement with Banco pertaining to our Brasilprev joint venture with no corresponding activity in 2011. For additional information, see "Investments Investment Results."

Total Expenses

Benefits, claims and settlement expenses decreased $607.1 million for the Corporate segment primarily due to a reduction in average covered medical members in our exited group medical insurance business. Benefits, claims and settlement expenses also decreased $189.5 million for the Retirement and Investor Services segment primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates and a decline in average account values, which primarily resulted from our decision to scale back our investment only business.

U.S. Insurance Solutions operating expenses increased $355.0 million, primarily due to higher DPAC amortization from the unlocking associated with integrated model changes in the current period and lower DPAC amortization in the prior period due to lowering long-term interest rate assumptions in our individual life insurance business. Retirement and Investor Services operating expenses also increased $107.1 million, primarily due to an increase in DPAC amortization expense resulting from generally level equity markets in 2011, compared to improving equity markets in 2010, and to a lesser extent, an increase in non-deferrable commission expense and management fees, which resulted from an increase in average account values. Partially offsetting these increases was a $231.4 million decrease for the Corporate segment primarily due to lower staff related costs in our exited group medical insurance business.

Income Taxes

The effective income tax rates were 24% and 15% for the years ended December 31, 2011 and 2010, respectively. The effective income tax rate for the year ended December 31, 2011, was lower than the U.S. corporate income tax rate of 35% ("U.S. statutory rate") primarily due to income tax deductions allowed for corporate dividends received, the presentation of taxes on our share of earnings generated from equity method investments and the interest exclusion from taxable income, which were partially offset by the impact of a court ruling on some uncertain tax positions. The effective income tax rate for the year ended December 31, 2010, was lower than the U.S. statutory rate primarily due to income tax deductions allowed for corporate dividends received, the presentation of taxes on our share of earnings generated from equity method investments and the interest exclusion from taxable income. The effective income tax rate increased to 24% from 15% for the years ended December 31, 2011 and 2010, respectively, primarily due to the impact of a 2011 court ruling on some uncertain tax positions.

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Net Income Available to Common Stockholders

Net income available to common stockholders increased primarily due to higher fees in our Retirement and Investor Services segment stemming from an increase in average account values, which resulted from continuing equity market improvement since the latter half of 2009. Our Principal Global Investors segment also had higher profitability due to higher fee revenues driven by an increase in average AUM, which resulted from continuing market improvement, as well as higher borrower fees from our real estate business resulting from higher transaction volumes and higher servicing fees. In addition, our Principal International segment had higher profitability primarily due to the strengthening of the Latin American currencies against the U.S. dollar, higher investment returns on assets not backing segment insurance products as a result of inflation in Chile during 2010 compared to deflation in 2009, and higher fee revenues driven by higher average AUM as a result of net customer cash flows and market performance. These increases in net income available to common stockholders were partially offset by an impairment of goodwill and severance accruals in the Corporate segment in the third quarter of 2010 associated with our decision to exit the group medical insurance business.

Table of Contents

The reduction in net realized capital losses was mostly offset by a corresponding increase in related DPAC amortization expense. Higher net realized capital losses in 2009 within our full service accumulation and individual annuities businesses resulted in lower DPAC amortization expense in 2009.

Total Revenues

Premiums decreased $205.3 million for the Corporate segment primarily due to a reduction in average covered medical members in our exited group medical insurance business. In addition, U.S. Insurance Solutions segment premiums decreased $90.9 million primarily due to a decrease in membership in our specialty benefits insurance business and the expected continued decline from the decreasing block of traditional life insurance business. Partially offsetting these decreases was an $85.0 million increase in Retirement and Investor Services segment premiums primarily due to an increase in sales of annuities with life contingencies within our individual annuities and full service payout businesses.

Fees increased $115.5 million for our Retirement and Investor Services segment primarily due to higher fee income stemming from an increase in average account values as a result of continuing equity market improvement since the latter half of 2009. Fees also increased $37.9 million for our Principal Global Investors segment primarily due to higher fee revenues driven by an increase in average AUM as well as higher borrower fees from our real estate business resulting from higher transaction volumes and higher servicing fees. In addition, fees increased $31.7 million for our Principal International segment primarily due to higher investment management fees driven by higher average AUM as a result of local market performance and net customer cash flows coupled with the strengthening of the Latin American currencies against the U.S. dollar.

Net investment income increased primarily due to higher inflation-based investment returns on average invested assets and cash as a result of inflation in Chile during 2010 compared to deflation in 2009. This increase was partially offset by a decrease in average invested assets and cash, excluding the fair value adjustment associated with fixed maturities and equity securities, primarily due to our decision to scale back our investment only business. For additional information, see "Investments Investment Results."

Net realized capital gains (losses) can be volatile due to other than temporary impairments of invested assets, mark-to-market adjustments of certain invested assets and our decision to sell invested assets. Net realized capital losses decreased primarily due to lower impairments, net of noncredit losses recognized in other comprehensive income and recoveries from sales, on fixed maturities, available-for-sale; a gain associated with the second quarter 2010 signing of our Shareholders Agreement with Banco pertaining to our Brasilprev joint venture and lower losses on commercial mortgage loans. These items were partially offset by an increase in the residential mortgage loan loss provision for our Bank and Trust Services business in 2010, which primarily related to the home equity portfolio. For additional information, see "Investments Investment Results."

Total Expenses

Benefits, claims and settlement expenses increased $169.2 million for the Principal International segment, primarily due to higher inflation-based interest crediting rates to customers in Chile and the strengthening of the Chilean peso against the U.S. dollar. Benefits, claims and settlement expenses also increased $89.4 million for the U.S. Insurance Solutions segment primarily due to higher gross claims and larger increases in reserves. Partially offsetting these increases was a $192.4 million decrease for the Corporate segment primarily due to a reduction in average covered medical members in our exited group medical insurance business. In addition, Retirement and Investor Services segment benefits, claims and settlement expenses decreased $62.3 million primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates and a decline in average account values in our investment only business, which primarily resulted from our decision to scale back this business.

Retirement and Investor Services operating expenses increased $177.8 million, primarily due to an increase in DPAC amortization expense resulting from more favorable DPAC unlocking in 2009 and, to a lesser extent, higher commission and distribution expenses resulting from an increase in sales and average account values. Operating expenses also increased $51.0 million for the Corporate segment primarily due to an impairment of goodwill and severance accruals associated with our decision to exit the group medical insurance business.

Income Taxes

The effective income tax rates were 15% and 13% for the years ended December 31, 2010 and 2009, 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, the presentation of taxes on our share of earnings generated from equity method investments and the interest exclusion from taxable income.

Table of Contents

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 16, Segment Information."

Retirement and Investor Services Segment

Retirement and Investor Services 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.

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

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in billions)	
Account values, beginning of period	**$ 178.3**	$ 163.9	$ 146.1
Net cash flow (1)	**4.3**	(2.1)	(3.4)
Credited investment performance (2)	**1.0**	17.1	22.3
Other	**(0.3)**	(0.6)	(1.1)
Account values, end of period	**$ 183.3**	$ 178.3	$ 163.9

(1) Includes net cash flow of $(0.7) billion, $(3.7) billion and $(5.2) billion for the years ended December 31, 2011, 2010 and 2009, respectively, resulting from the decision to scale back our investment only business.

(2) The decrease in credited investment performance is primarily due to lower equity markets in the second half of 2011.

Retirement and Investor Services Segment Summary Financial Data

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

	For the year ended December 31,			Increase (decrease)	
	2011	**2010**	**2009**	**2011 vs. 2010**	**2010 vs. 2009**
			(in millions)		
Operating revenues:					
Premiums and other considerations	**$ 390.4**	$ 332.2	$ 247.2	$ 58.2	$ 85.0
Fees and other revenues	**1,431.2**	1,361.3	1,243.9	69.9	117.4
Net investment income	**2,252.5**	2,430.9	2,550.4	(178.4)	(119.5)
Total operating revenues	**4,074.1**	4,124.4	4,041.5	(50.3)	82.9
Expenses:					
Benefits, claims and settlement expenses, including dividends to policyholders	**1,996.7**	2,128.7	2,217.5	(132.0)	(88.8)
Operating expenses	**1,322.6**	1,240.8	1,169.4	81.8	71.4

Total expenses	**3,319.3**	3,369.5	3,386.9	(50.2)	(17.4)
Operating earnings before income taxes	**754.8**	754.9	654.6	(0.1)	100.3
Income taxes	**173.7**	170.5	144.2	3.2	26.3
Operating earnings	**$ 581.1**	$ 584.4	$ 510.4	$ (3.3)	$ 74.0

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Operating Earnings

Operating earnings decreased $9.9 million in our investment only business primarily due to a decrease in fees, which stems from the early extinguishment of medium term notes in 2010 with no corresponding experience in 2011 and a decline in average account values resulting from negative net cash flow as the pace of contractual maturities remains higher than the amount of new deposits. In addition, operating earnings decreased $6.6 million and $5.6 million in our full service accumulation and individual annuities businesses, respectively, primarily due to an increase in DPAC amortization expense resulting from generally level equity markets in 2011, compared to improving equity markets in 2010. To a lesser extent, full service accumulation operating earnings decreased due to an increase in non-deferrable commission expense and management fees, which resulted from an increase in average account values. Partially offsetting the decreases in operating earnings was an $8.8 million increase in our Principal Funds business primarily due to higher fees stemming from an increase in average account values, which resulted from generally positive equity market performance since 2010. Furthermore, operating earnings increased $5.9 million in our full service payout business primarily due to a decrease in change in reserves resulting from a larger than normal reserve increase in the third quarter of 2010 with no corresponding activity in 2011, as well as a larger reserve release due to favorable mortality experience in 2011.

Operating Revenues

Premiums increased $117.1 million in our individual annuities business primarily due to an increase in sales of annuities with life contingencies stemming from expanding opportunities with our bank distribution partners. Partially offsetting the increase in premiums was a $58.9 million decrease in our full service payout business primarily due to a decrease in sales of single premium group annuities with life contingencies. The single premium product, which is typically used to fund defined benefit plan terminations, can generate large premiums from very few customers and therefore tends to vary from period to period.

Fees increased $42.3 million and $23.1 million in our Principal Funds and full service accumulation businesses, respectively, primarily due to higher fees stemming from an increase in average account values, which resulted from generally positive equity market performance since 2010.

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

Total Expenses

Benefits, claims and settlement expenses decreased $108.3 million in our investment only business primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates and a decline in average account values, which primarily resulted from our decision to scale back this business. In addition, benefits, claims and settlement expenses decreased $77.0 million in our full service payout business primarily due to a decrease in change in reserves resulting from a decrease in sales of single premium group annuities with life contingencies and, to a lesser extent, a larger than normal reserve increase in the third quarter of 2010 with no corresponding activity in 2011, as well as a larger reserve release due to favorable mortality experience in 2011. Furthermore, benefits, claims and settlement expenses decreased $37.6 million in our full service accumulation business primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates. Partially offsetting the decreases in benefits, claims and settlement expenses was an $89.8 million increase in our individual annuities business primarily due to an increase in change in reserves resulting from higher sales of annuities with life contingencies and continued growth in the block of business.

Operating expenses increased $42.5 million and $21.1 million in our full service accumulation and individual annuities businesses primarily due to an increase in DPAC amortization expense resulting from generally level equity markets in 2011, compared to improving equity markets in 2010. To a lesser extent, operating expenses increased in our full service accumulation business due to an increase in non-deferrable commission expense and management fees, which resulted from an increase in average account values. In addition, operating expenses increased $28.5 million in our Principal Funds business primarily due to higher distribution and management fees resulting from an increase in sales and average account values.

Income Taxes

The effective income tax rate for the segment was 23% for the both the years ended December 31, 2011 and 2010. The effective income tax rate was lower than the U.S. statutory rate primarily as a result of income tax deductions allowed for corporate dividends received and the interest exclusion from taxable income.

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Operating Earnings

Operating earnings increased $48.9 million and $16.2 million in our full service accumulation and Principal Funds businesses, respectively, primarily due to higher fees stemming from an increase in average account values, which resulted from continuing equity market improvement since the latter half of 2009. In addition, operating earnings increased in our Principal Fund business due to strong cash flows into the Global Diversified Income Fund, Preferred Securities Fund and High Yield Fund. Furthermore, operating earnings increased $17.8 million in our individual annuities business due to an increase in average account values, which resulted from continuing equity market improvement since the latter half of 2009 and growth in this block of business. Partially offsetting the increase in operating earnings was an $18.5 million decrease in our investment only business primarily due to an opportunistic early extinguishment of medium-term notes in 2009 with limited corresponding activity in 2010.

Operating Revenues

Premiums increased $49.0 million in our full service payout business primarily due to an increase in sales of single premium group annuities with life contingencies. The single premium product, which is typically used to fund defined

Table of Contents

benefit plan terminations, can generate large premiums from very few customers and therefore tends to vary from period to period. In addition, premiums increased $36.0 million in our individual annuities business primarily due to an increase in sales of annuities with life contingencies.

Fees increased $73.0 million and $16.6 million in our full service accumulation and individual annuities businesses, respectively, primarily due to higher fee income stemming from an increase in average account values as a result of continuing equity market improvement since the latter half of 2009. In addition, fees increased $51.6 million in our Principal Funds business primarily due to an increase in management fee income and distribution income stemming from an increase in sales and average account values, which primarily resulted from continuing equity market improvement since the latter half of 2009. Partially offsetting the increase in fees was a $26.8 million decrease in our investment only business primarily due to fees received in 2009 relating to an opportunistic early extinguishment of medium-term notes with limited corresponding activity in 2010.

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

Total Expenses

Benefits, claims and settlement expenses decreased $123.1 million in our investment only business primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates and a decline in average account values, which primarily resulted from our decision to scale back this business. In addition, benefits, claims and settlement expenses decreased $41.4 million in our full service accumulation business primarily due to a decrease in cost of interest credited stemming from lower variable crediting rates. Partially offsetting the decrease in benefits, claims and settlement expenses was a $45.4 million increase in our full service payout business primarily due to an increase in change of reserves resulting from an increase in sales of single premium group annuities with life contingencies. Furthermore, benefits, claims and settlement expenses increased $31.6 million in our individual annuities business primarily due to an increase in change of reserves resulting from higher sales of annuities with life contingencies and continued growth in the block of business.

Operating expenses in our full service accumulation business increased $34.7 million primarily due to an increase in DPAC amortization expense resulting from more favorable DPAC unlocking in 2009. In addition, operating expenses increased $24.1 million in our Principal Funds business primarily due to higher distribution expenses resulting from an increase in sales and average account values. Furthermore, operating expenses in our individual annuities business increased $16.7 million primarily due to an increase in DPAC amortization expense resulting from continued growth in the block of business.

Income Taxes

The effective income tax rates for the segment were 23% and 22% for the years ended December 31, 2010 and 2009, respectively. The effective income tax rates were lower than the U.S. statutory rate primarily as a result of income tax deductions allowed for corporate dividends received and the interest exclusion from taxable income.

Principal Global Investors Segment

Principal Global Investors Trends

Our overall AUM increased $7.7 billion in 2011 primarily due to improved market performance as well as the acquisition of Finisterre Capital and Origin in 2011. While we have continued to experience success in winning institutional asset management mandates and other client deposits, we have also continued to see client withdrawals driven by portfolio rebalancing and asset allocation strategies and client mergers.

The following table provides a summary of Principal Global Investor's affiliated and third-party AUM as of the periods indicated:

	Principal Global Investors		
As of	Affiliated AUM	Third-party AUM	Total AUM
		(in billions)	
December 31, 2011	**$ 145.4**	**$ 82.4**	**$ 227.8**
December 31, 2010	141.4	78.7	220.1
December 31, 2009	131.5	73.8	205.3

Principal Global Investors Segment Summary Financial Data

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

Table of Contents

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

	For the year ended December 31,		
	2011	2010	2009
	(in billions)		
AUM, beginning of period	**$ 220.1**	$ 205.3	$ 190.0
Net cash flow (1)	**(1.8)**	(7.0)	(7.7)
Investment performance (2)	**6.1**	22.3	28.5
Operations acquired (3)	**4.3**		
Operations disposed (4)			(3.8)
Other	**(0.9)**	(0.5)	(1.7)
AUM, end of period	**$ 227.8**	$ 220.1	$ 205.3

(1) Includes net cash flow of $(0.7) billion, $(3.7) billion and $(5.2) billion for the years ended December 31, 2011, 2010 and 2009, respectively, resulting from the Retirement and Investor Services segment's decision to scale back its investment only business.

(2) The decrease in investment performance is primarily due to lower equity markets in the second half of 2011.

(3) Reflects acquisition of Finisterre Capital and Origin in 2011.

(4) Reflects disposition of certain asset management contracts within Post Advisory Group, LLC in 2009.

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

	For the year ended December 31,			Increase (decrease)	
	2011	2010	2009	2011 vs. 2010	2010 vs. 2009
	(in millions)				
Operating revenues:					
Fees and other revenues	**$ 531.2**	$ 467.2	$ 429.2	$ 64.0	$ 38.0
Net investment income	**15.1**	14.2	10.2	0.9	4.0
Total operating revenues	**546.3**	481.4	439.4	64.9	42.0
Expenses:					
Total expenses	**429.3**	384.2	375.6	45.1	8.6
Operating earnings before income taxes	**117.0**	97.2	63.8	19.8	33.4
Income taxes	**41.0**	33.7	21.0	7.3	12.7
Operating earnings attributable to noncontrolling interest	**2.0**	5.0	4.6	(3.0)	0.4
Operating earnings	**$ 74.0**	$ 58.5	$ 38.2	$ 15.5	$ 20.3

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Operating Earnings

Operating earnings increased due to higher fee revenues driven by an increase in average AUM. In addition, operating earnings increased due to higher borrower fees from our real estate business resulting from higher transaction volumes and higher servicing fees.

Operating Revenues

Fees increased primarily due to an increase in average AUM as well as increased performance fees in our equity business and higher borrower fees from our real estate business.

Net investment income increased primarily due to earnings of our equity method investment in Finisterre Capital, which was acquired in July 2011.

Total Expenses

Total expenses increased primarily due to higher staff related costs resulting from higher compensation expense, as well as other expenses generally related to our acquisition of Origin in 2011.

Income Taxes

The effective income tax rate for the segment was 35% for both the years ended December 31, 2011 and 2010.

Table of Contents

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Operating Earnings

Operating earnings increased primarily due to higher fee revenues driven by an increase in average AUM as a result of continued market improvement since the latter half of 2009. In addition, operating earnings increased due to higher borrower fees from our real estate business resulting from higher transaction volumes and higher servicing fees.

Operating Revenues

Fees increased primarily due to an increase in average AUM as well as higher borrower fees from our real estate business.

Net investment income increased primarily due to losses in an equity method investment in 2009 with very little activity in 2010.

Total Expenses

Total expenses increased primarily due to higher staff related costs resulting from higher compensation expense, which was partially offset by lower intangible amortization expense as certain intangibles were fully amortized as of December 31, 2009.

Income Taxes

The effective income tax rates for the segment were 35% and 33% for the years ended December 31, 2010 and 2009, respectively. The effective income tax rate was lower than the U.S. statutory rate for the year ended December 31, 2009, primarily due to inclusion of income attributable to noncontrolling interest in pre-tax operating earnings with no corresponding change in income taxes reported by us as the controlling interest.

Principal International Segment

Principal International Trends

Our Principal International 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.

Principal International Segment Summary Financial Data

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

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

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in billions)	
AUM, beginning of period	**$ 45.8**	$ 34.6	$ 23.1

Net cash flow		**5.5**		4.7		3.2
Investment performance		**3.5**		4.1		4.0
Operations acquired (1)		**3.1**		0.7		
Effect of exchange rates		**(4.8)**		1.9		4.5
Other		**(0.3)**		(0.2)		(0.2)
AUM, end of period	**$**	**52.8**	$	45.8	$	34.6

(1) Reflects the acquisition of HSBC AFORE in Mexico in August 2011.

Table of Contents

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

	For the year ended December 31,			Increase (decrease)	
	2011	2010	2009	2011 vs. 2010	2010 vs. 2009
	(in millions)				
Operating revenues:					
Premiums and other considerations	**$ 264.5**	$ 255.2	$ 239.1	$ 9.3	$ 16.1
Fees and other revenues	**168.5**	147.7	116.0	20.8	31.7
Net investment income	**476.5**	377.0	207.0	99.5	170.0
Total operating revenues	**909.5**	779.9	562.1	129.6	217.8
Expenses:					
Benefits, claims and settlement expenses	**583.1**	497.2	327.6	85.9	169.6
Operating expenses	**168.6**	145.1	115.2	23.5	29.9
Total expenses	**751.7**	642.3	442.8	109.4	199.5
Operating earnings before income taxes	**157.8**	137.6	119.3	20.2	18.3
Income taxes (benefits)	**4.0**	(0.4)	0.5	4.4	(0.9)
Operating earnings (losses) attributable to noncontrolling interest	**(0.2)**	1.1	(0.1)	(1.3)	1.2
Operating earnings	**$ 154.0**	$ 136.9	$ 118.9	$ 17.1	$ 18.0

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Operating Earnings

Operating earnings increased primarily due to higher fees driven by higher average AUM as a result of net customer cash flows, market performance and the HSBC AFORE acquisition; the strengthening of the Latin American currencies against the U.S. dollar and higher earnings in our equity method investment in Brazil despite a reduction in the economic interest during 2Q 2010.

Operating Revenues

Premiums in Chile increased $9.6 million primarily due to the strengthening of the Chilean peso against the U.S. dollar, which was partially offset by lower sales of single premium annuities with life contingencies.

Fees and other revenues increased primarily due to higher investment management fees driven by higher average AUM in Mexico as a result of the HSBC AFORE acquisition.

Net investment income increased primarily due to higher inflation-based investment returns on average invested assets and cash as a result of higher inflation in Chile, the strengthening of the Latin American currencies against the U.S. dollar and higher earnings in our equity method investment in Brazil despite a reduction in the economic interest during 2Q 2010.

Total Expenses

Benefits, claims and settlement expenses in Chile increased $87.7 million primarily due to higher inflation-based interest crediting rates to customers and the strengthening of the Chilean peso against the U.S. dollar.

Operating expenses increased primarily due to expenses related to the HSBC AFORE acquisition in Mexico, higher compensation expenses across the segment and the strengthening of the Latin American currencies against the U.S. dollar.

Income Taxes

The effective income tax rates for the segment were 3% and 0% for the years ended December 31, 2011 and 2010, respectively. The effective income tax rates were lower than the U.S. statutory rate primarily due to the presentation of taxes on our share of earnings generated from our equity method investments. Specifically, our share of earnings generated from equity method investments, net of foreign taxes incurred, are reported within net investment income whereas any residual U.S. tax expense or benefit related to equity method investments is reported in income taxes. Lower tax rates of foreign jurisdictions also contributed to the lower effective income tax rates.

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Operating Earnings

Operating earnings increased primarily due to the strengthening of the Latin American currencies against the U.S. dollar, higher investment returns on assets not backing segment insurance products as a result of inflation in Chile during 2010 compared to deflation in 2009 and higher fee revenues driven by higher average AUM as a result of net customer cash flows and market performance. These increases were partially offset by 2009 expense savings initiatives to align with

Table of Contents

2009 revenues and lower earnings in our equity method investment in Brazil as a result of the reduction in our economic interest.

Operating Revenues

Premiums in Chile increased $15.7 million primarily due to the strengthening of the Chilean peso against the U.S. dollar, which was partially offset by lower sales of single premium annuities with life contingencies.

Fees and other revenues in Mexico and Chile collectively increased $25.5 million primarily due to higher investment management fees driven by higher average AUM as a result of local market performance and net customer cash flows. In addition, fees and other revenues increased due to the strengthening of the Latin American currencies against the U.S. dollar.

Net investment income in Chile increased $169.8 million primarily due to higher inflation-based investment returns on average invested assets and cash as a result of inflation in 2010 compared to deflation in 2009 and the strengthening of the Chilean peso against the U.S. dollar.

Total Expenses

Benefits, claims and settlement expenses in Chile increased $166.8 million primarily due to higher inflation-based interest crediting rates to customers and the strengthening of the Chilean peso against the U.S. dollar.

Operating expenses increased primarily due to 2009 expense savings initiatives to align with 2009 revenues, higher DPAC amortization resulting from net unlocking and true-up adjustments in Mexico and the strengthening of the Latin American currencies against the U.S. dollar.

Income Taxes

The effective income tax rate for the segment was 0% for both the years ended December 31, 2010 and 2009. The effective income tax rate was lower than the U.S. statutory rate primarily due to the presentation of taxes on our share of earnings generated from our equity method investments. Specifically, our share of earnings generated from equity method investments, net of foreign taxes incurred, are reported within net investment income whereas any residual U.S. tax expense or benefit related to equity method investments is reported in income taxes. Lower tax rates of foreign jurisdictions also contributed to the lower effective income tax rate.

U.S. Insurance Solutions Segment

Individual Life Insurance Trends

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

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

For the year ended	Universal and variable universal life insurance fee revenues	Traditional life insurance premiums
	(in millions)	
December 31, 2011 (1)	**$ 515.9**	**$ 502.5**
December 31, 2010	382.5	517.9
December 31, 2009	354.4	557.3

(1) Includes $48.5 million of fee revenues due to the unlocking of unearned revenue resulting from integrated model changes in our individual life insurance business.

Specialty Benefits Insurance Trends

Premium and fee growth for the individual disability line of our specialty benefits insurance business was driven by solid sales and retention. The group lines experienced a decline between 2009 and 2010 due to decreases in membership of existing employer customers and slightly lower sales. This changed, however, between 2010 and 2011 due to strong sales, increased membership of existing employer customers and stable lapse rates.

Table of Contents

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	Group life insurance	Group disability insurance	Individual disability insurance	Wellness (1)
	Premium and fees (in millions)				
December 31, 2011	**$ 558.9**	**$ 319.1**	**$ 274.6**	**$ 216.3**	**$ 8.3**
December 31, 2010	518.9	315.0	265.6	196.5	
December 31, 2009	539.9	333.2	290.8	181.6	

(1) After making the decision to exit the group medical insurance business, wellness became part of the specialty benefits division starting January 1, 2011.

U.S. Insurance Solutions Segment Summary Financial Data

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

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

	For the year ended December 31,			Increase (decrease)	
	2011	2010	2009	2011 vs. 2010	2010 vs. 2009
	(in millions)				
Operating revenues:					
Premiums and other considerations	**$ 1,724.0**	$ 1,685.7	$ 1,776.6	$ 38.3	$ (90.9)
Fees and other revenues	**570.7**	422.7	399.2	148.0	23.5
Net investment income	**689.7**	666.7	636.8	23.0	29.9
Total operating revenues	**2,984.4**	2,775.1	2,812.6	209.3	(37.5)
Expenses:					
Benefits, claims and settlement expenses	**1,549.5**	1,718.0	1,651.2	(168.5)	66.8
Dividends to policyholders	**207.6**	218.4	239.4	(10.8)	(21.0)
Operating expenses	**909.8**	553.5	620.1	356.3	(66.6)
Total expenses	**2,666.9**	2,489.9	2,510.7	177.0	(20.8)
Operating earnings before income taxes	**317.5**	285.2	301.9	32.3	(16.7)
Income taxes	**101.6**	91.5	97.8	10.1	(6.3)
Operating earnings	**$ 215.9**	$ 193.7	$ 204.1	$ 22.2	$ (10.4)

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Operating Earnings

Operating earnings increased due to lowering our long-term interest rate assumptions in the prior period in our individual life insurance business, which impacted reserves, DPAC and other actuarial balances and growth in our specialty benefits, universal life and variable universal life lines of business.

Operating Revenues

Premiums increased $69.9 million in our specialty benefits insurance business due to strong sales, stabilizing existing case membership and improved lapse rates. Premiums decreased $31.6 million in our individual life insurance business primarily due to the expected continued decline from the decreasing block of traditional life insurance business.

Fees and other revenues increased $136.8 million in our individual life insurance business due to growth in the universal life and variable universal life lines of business and the unlocking of unearned revenue associated with integrated model changes.

Total Expenses

Benefits, claims and settlement expenses decreased $219.1 million in our individual life insurance business primarily due to integrated model changes in the current period and lowering our long-term interest rate assumptions in the prior period. This was partially offset by a $50.6 million increase resulting from continued growth in our specialty benefits insurance business.

Table of Contents

Operating expenses increased due to higher DPAC amortization in our individual life insurance business from the unlocking associated with integrated model changes in the current period and lower DPAC amortization in the prior period due to lowering our long-term interest rate assumptions, which had partially offsetting impacts on fee revenues and benefit expense. In addition, operating expenses increased due to growth in our specialty benefits, universal life and variable universal life lines of business.

Income Taxes

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

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Operating Earnings

Operating earnings decreased primarily due to lowering our long-term interest rate assumptions, which impacted reserves, DPAC and other actuarial balances in our individual life insurance business.

Operating Revenues

Premiums decreased $47.3 million in our specialty benefits insurance business due to a decrease in membership driven by lapses exceeding sales during the first half of the year and a slight decline in existing-case covered lives. Premiums decreased $43.6 million in our individual life insurance business primarily due to the expected continued decline from the decreasing block of traditional life insurance business.

Fees and other revenues increased $25.7 million in our individual life insurance business due to growth in the universal life and variable universal life lines of business.

Net investment income increased primarily due to an increase in average annualized investment yields and, to a lesser extent, an increase in average invested assets.

Total Expenses

Benefits, claims and settlement expenses increased $96.2 million in our individual life insurance business as a result of higher gross claims and larger increases in reserves. While a substantial amount of the higher gross claims are offset by the benefit of reinsurance, under U.S. GAAP we defer much of the benefit of reinsurance, which causes an increase in reported net benefits in the current period and lower DPAC amortization. Partially offsetting this increase in benefits, claims and settlement expenses was a decrease of $29.4 million in our specialty benefits insurance business due to a decrease in membership.

Dividends to policyholders decreased $21.0 million, primarily from updating the policyholder dividend scale to reflect the experience of the Closed Block.

Operating expenses decreased $55.4 million in our individual life insurance business primarily related to lower DPAC amortization, which was offset by a corresponding increase in gross claims.

Income Taxes

The effective income tax rate for the segment was 32% for both the years ended December 31, 2010 and 2009. The effective income tax rate was lower than the U.S. statutory rate as a result of the interest exclusion from taxable income and income tax deductions allowed for corporate dividends received.

Table of Contents

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)	
	2011	**2010**	**2009**	**2011 vs. 2010**	**2010 vs. 2009**
			(in millions)		
Operating revenues:					
Total operating revenues	**$ (189.2)**	$ (118.9)	$ (143.4)	$ (70.3)	$ 24.5
Expenses:					
Total expenses	**(5.2)**	38.0	33.4	(43.2)	4.6
Operating losses before income taxes and preferred stock dividends	**(184.0)**	(156.9)	(176.8)	(27.1)	19.9
Income tax benefits	**(72.9)**	(61.4)	(71.4)	(11.5)	10.0
Preferred stock dividends	**33.0**	33.0	33.0		
Operating earnings (losses) attributable to noncontrolling interest	**2.8**	0.2	(0.1)	2.6	0.3
Operating losses	**$ (146.9)**	$ (128.7)	$ (138.3)	$ (18.2)	$ 9.6

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Operating Losses

Operating losses increased due to a decrease in earnings on average invested assets for the segment, representing capital that has not been allocated to any other segment. This increase was partially offset by a reduction in corporate overhead expenses needed to support the exited group medical insurance business and the 2011 transition of wellness and non-medical fee-for-service claim administration businesses, which had operating losses in 2010, from this segment to the U.S. Insurance Solutions segment.

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Operating Losses

Operating losses decreased due to an increase in earnings on average invested assets for the segment, representing capital that has not been allocated to any other segment. This decrease was partially offset by higher interest expense on corporate debt.

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.

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

Table of Contents

Our liquidity is supported by a portfolio of U.S. government and agency and residential pass-through government-backed securities, of which we held $4.5 billion as of December 31, 2011, that may be utilized to bolster our liquidity position, as collateral for secured borrowing transactions with various third parties or by disposing of the securities in the open market if needed. As of December 31, 2011, approximately $11.3 billion, or 98%, of our institutional guaranteed investment contracts and funding agreements cannot be redeemed by contractholders prior to maturity. Our life insurance and annuity liabilities contain provisions limiting early surrenders.

As of December 31, 2011 and 2010, we had short-term credit facilities with various financial institutions in an aggregate amount of $725.0 million and $719.8 million, respectively. As of December 31, 2011 and 2010, we had $105.2 million and $107.9 million, respectively, of outstanding borrowings related to our credit facilities, with $24.9 million of assets pledged as support as of December 31, 2011. None of these credit arrangements, other than our commercial paper back-stop facility, are committed facilities. Due to the financial strength and the strong relationships we have with these providers, as well as the small size of these facilities, we are comfortable that there is a very low risk that the financial institutions would not be able to fund these facilities. As of both December 31, 2011 and 2010, our credit facilities included a $579.0 million commercial paper program, of which $50.0 million was outstanding as of both December 31, 2011 and 2010. 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, 2011 and 2010. The back-stop facility is a five year facility that matures in June 2012. The facility is supported by fourteen banks, most if not all of which have other relationships with us. We have no reason to believe that our current providers would be unable or unwilling to fund the facility if necessary. We are in the process of renewing the facility. It will continue to provide 100% support for our commercial paper program.

The Holding Companies: Principal Financial Group, Inc. and Principal Financial Services, Inc. The principal sources of funds available to our parent holding company, PFG, to meet its obligations, including the payments of dividends on common stock, debt service and the repurchase of stock, are dividends from subsidiaries as well as its ability to borrow funds at competitive rates and raise capital to meet operating and growth needs. Dividends from Principal Life, our primary subsidiary, are limited by Iowa law. Under Iowa laws, Principal Life may pay dividends only from the earned surplus arising from its business and must receive the prior approval of the Insurance Commissioner of the State of Iowa ("the Commissioner") to pay stockholder dividends or make any other distribution if such distributions would exceed certain statutory limitations. Iowa law gives the Commissioner discretion to disapprove requests for distributions in excess of these limits. In general, the current statutory limitations are the greater of (i) 10% of Principal Life's statutory policyholder surplus as of the previous year-end or (ii) the statutory net gain from operations from the previous calendar year. Based on these limitations, Principal Life could distribute approximately $507.7 million in 2012.

Principal Life could have paid approximately $509.7 million in statutory dividends in 2011 based on its 2010 statutory financial results without being subject to the limitations on payment of stockholder dividends. Principal Life distributed paid-in and contributed surplus in the amount of $500.0 million to its parent company in 2011, which counts toward Principal Life's distribution capacity for the year. In addition, Principal Life requested and received permission from the Commissioner to pay an extraordinary dividend in the amount of $250.0 million, which was paid by Principal Life to its parent in 2011.

Principal Life could have paid approximately $608.7 million in statutory dividends in 2010 based on its 2009 statutory financial results without being subject to the limitations on payment of stockholder dividends. No dividends were paid as of December 31, 2010; however, on June 21, 2010, Principal Life distributed paid-in and contributed surplus in the amount of $300.0 million to its parent company.

Principal Life could have paid approximately $651.3 million in statutory dividends in 2009 based on its 2008 statutory financial results without being subject to the limitations on payment of stockholder dividends. On March 27, 2009, a $645.0 million ordinary dividend was paid by Principal Life to its parent company from internal sources of liquidity. Following our second quarter issuance of debt and equity, on May 20, 2009, a $500.0 million capital contribution was made to Principal Life from its parent company. An additional $300.0 million capital contribution was made to Principal Life from its parent company on December 31, 2009.

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

55

Table of Contents

Net cash provided by operating activities was $ 2,713.3 million, $2,791.7 million and $2,243.0 million for the years ended December 31, 2011, 2010 and 2009, 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 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 2011 compared to 2010 was the result of a decrease in premiums and other consideration received, partially offset by a decrease in claims, due to our decision to exit the group medical insurance business. The decrease in cash provided by operating activities was also offset by fluctuations in receivables and payables associated with the timing of settlement. The increase in cash provided by operating activities in 2010 compared to 2009 was the result of increased cash flows from trading securities as well as an increase in fees and other revenue received.

Net cash used in investing activities was $202.1 million for the year ended December 31, 2011, compared to net cash provided by investing activities of $27.5 million and $1,026.8 million for the years ended December 31, 2010 and 2009, respectively. The increase in cash used in investing activities in 2011 compared to 2010 was primarily due to purchases of interest in subsidiaries in 2011. The decrease in cash provided by investing activities in 2010 compared to 2009 was primarily due to an increase in net purchases of investments.

Net cash used in financing activities was $1,554.7 million, $3,182.2 million and $3,637.4 million for the years ended December 31, 2011, 2010 and 2009, respectively. The decrease in cash used in financing activities in 2011 compared to 2010 is primarily due to a decrease in net withdrawals of Principal Life general account investment contracts, partially offset by an increase in cash used to repurchase treasury stock in 2011. The decrease in cash used in financing activities in 2010 compared to 2009 is primarily due to a decrease in net withdrawals of Principal Life general account investment contracts. Net withdrawals were higher in 2009 primarily due to our decision to scale back our investment only business. Also contributing to the decrease in cash used in financing activities was net proceeds from short-term debt in 2010 compared to net repayments of short-term debt in 2009. These increases were partially offset by cash received from the issuance of common stock and long-term debt in 2009 with no corresponding activity in 2010.

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. In May 2009, we issued common stock and senior debt securities under 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 9, 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 9, Debt."

Stockholders' Equity. Proceeds from the issuance of our common stock were $25.9 million, $20.6 million and $1,123.0 million in 2011, 2010 and 2009, respectively.

The following table summarizes our return of capital to common stockholders.

	For the year ended December 31,		
	2011	**2010**	**2009**
	(in millions)		
Dividends to stockholders	**$ 213.7**	$ 176.2	$ 159.5
Repurchase of common stock	**556.4**	2.6	4.1
Total cash returned to stockholders	**$ 770.1**	$ 178.8	$ 163.6
Number of shares repurchased	**21.1**	0.1	0.3

For additional stockholders' equity information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 13, Stockholders' Equity."

Table of Contents

Capitalization

The following table summarizes our capital structure.

	December 31, 2011	December 31, 2010
	(in millions)	
Debt:		
Short-term debt	**$ 105.2**	$ 107.9
Long-term debt	**1,564.8**	1,583.7
Total debt	**1,670.0**	1,691.6
Stockholders' equity:		
Equity excluding accumulated other comprehensive income	**9,435.1**	9,455.4
Total capitalization excluding accumulated other comprehensive income	**$ 11,105.1**	$ 11,147.0
Debt to equity excluding accumulated other comprehensive income	**18%**	18%
Debt to capitalization excluding accumulated other comprehensive income	**15%**	15%

As of December 31, 2011, we had $576.2 million of excess capital, consisting of cash and highly liquid assets in the holding companies available for debt maturities, interest and preferred dividend expenses and other holding company obligations. We continue to maintain sufficient capital levels in Principal Life based on our current financial strength ratings.

Contractual Obligations

The following table presents payments due by period for long-term contractual obligations as of December 31, 2011.

		Payments due in year ending			
Contractual Obligations (1)	**Total Payments**	**2012**	**2013 - 2014**	**2015 - 2016**	**2017 and thereafter**
			(in millions)		
Contractholder funds (2)	**$ 64,345.9**	**$ 6,040.6**	**$ 12,208.4**	**$ 7,046.5**	**$ 39,050.4**
Future policy benefits and claims (3)	**34,492.5**	**2,016.6**	**3,101.7**	**2,918.1**	**26,456.1**
Long-term debt (4)	**1,564.8**	**2.7**	**415.9**	**95.1**	**1,051.1**
Certificates of deposit (5)	**909.9**	**647.6**	**171.0**	**91.0**	**0.3**
Other long-term liabilities (6)	**1,803.9**	**1,514.4**	**82.7**	**64.7**	**142.1**
Capital leases	**11.4**	**4.3**	**6.6**	**0.5**	
Long-term debt interest	**1,486.6**	**114.8**	**206.8**	**158.2**	**1,006.8**
Operating leases (7)	**208.0**	**45.8**	**66.3**	**34.1**	**61.8**
Purchase obligations (8)	**573.8**	**543.5**	**18.7**	**11.6**	
Total contractual obligations	**$ 105,396.8**	**$ 10,930.3**	**$ 16,278.1**	**$ 10,419.8**	**$ 67,768.6**

---

(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 statements 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 8, 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 statements of financial position as of December 31, 2011. The liability amount in our consolidated statements of financial position reflects either the account value (in the case of individual fixed annuities, universal life insurance and GICs) or the par value plus accrued interest and other adjustments (in the case of funding agreements and other investment contracts).

(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 statements of financial position as of December 31, 2011. The liability amount in our consolidated statements of financial position 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 9, 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 statements of financial position.

(6) Other long-term liabilities include other liabilities reflected in the consolidated statements of financial position that are contractual, non-cancelable and long-term in nature. The total payments primarily relate to checking and savings deposits as well as premium associated with purchased option contracts where payments are made over the life of the contract. 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, office furniture and office 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 11, 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 position. The net funded status represents the differences between the fair value of plan assets and the projected benefit obligation for pension plans and other postretirement plans. 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 postretirement benefit obligation was $427.9 million pre-tax and $207.0 million pre-tax as of December 31, 2011 and 2010, respectively. Nonqualified pension plan assets are not included as part of the funding status mentioned above. The nonqualified pension plan assets are held in Rabbi trusts for the benefit of all nonqualified plan participants. The assets held in a Rabbi trust are available to satisfy the claims of general creditors only in the event of bankruptcy. Therefore, these assets are fully consolidated in our consolidated statements of financial position and are not reflected in our funded status as they do not qualify as plan assets under U.S. GAAP. The market value of assets held in these trusts was $281.2 million and $265.3 million as of December 31, 2011 and 2010, respectively.

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 2012 in the range of $75-$125 million. This includes funding for both our qualified and nonqualified pension plans. We may contribute to our other postretirement benefit plans in 2012 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 $56.3 million as of December 31, 2011.

We have made commitments to fund certain limited partnerships in which we are a limited partner. As of December 31, 2011, the amount of unfunded commitments was $37.0 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 3, Variable Interest Entities." We have made commitments to fund certain limited partnerships, as previously discussed in "Contractual Commitments", some of which are classified as unconsolidated variable interest entities ("VIEs").

Guarantees and Indemnifications. For guarantee and indemnification information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 12, Contingencies, Guarantees and Indemnifications" under the caption, "Guarantees and Indemnifications."

Financial Strength Rating and Credit Ratings

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

A.M. Best Company, Inc., Fitch Rating Ltd., Moody's Investors Service and Standard & Poor's 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. These rating agencies 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 rating agency.

Table of Contents

A.M. Best, Fitch, Moody's and Standard & Poor's maintain a stable outlook on the U.S. life insurance sector. However, these rating agencies note that current challenges for the industry such as global sovereign uncertainty, equity market volatility, impact of sustained low interest rates, weakness in the real estate market, lingering unemployment and weak consumer confidence are putting pressure on the stable outlook.

The financial strength ratings of Principal Life and Principal National Life Insurance Company were affirmed with no change in outlook by Moody's in August 2011 and by A.M. Best and S&P in December 2011. In June 2011, Fitch affirmed the ratings of Principal Life and Principal National Life Insurance Company and changed the outlook to stable from negative.

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

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

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

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

Impacts of Income Taxes

For income tax information, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 10, Income Taxes."

Fair Value Measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three levels for disclosure purposes. The fair value hierarchy gives the highest priority (Level 1) to quoted prices in active markets for identical assets or liabilities and gives the lowest priority (Level 3) to unobservable inputs. An asset or liability's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 14, Fair Value Measurements" for further details, including a reconciliation of changes in Level 3 fair value measurements.

As of December 31, 2011, 41% of our net assets (liabilities) were Level 1, 55% were Level 2 and 4% were Level 3. Excluding separate account assets as of December 31, 2011, 3% of our net assets (liabilities) were Level 1, 96% were Level 2 and 1% were Level 3.

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

Changes in Level 3 fair value measurements

Net assets (liabilities) measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2011, were $4,647.3 million as compared to $4,691.4 million as of December 31, 2010. The slight net decrease was primarily due to net transfers out of Level 3 and into Level 2 offset in part by unrealized gains on real estate separate account assets. The transfers included certain private corporate bonds we are now able to price using a matrix valuation approach as well as certain separate account assets for which we are now able to obtain pricing from a recognized third party pricing vendor.

Net assets (liabilities) measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2010, were $4,691.4 million as compared to $5,276.5 million as of December 31, 2009. The decrease is primarily related to fixed maturities, available-for-sale and separate account assets. The decrease in fixed maturities, available-for-sale is primarily the result of our obtaining prices from third party pricing vendors versus relying on broker quotes or internal pricing models for certain structured securities, resulting in the transfer of those assets out of Level 3 to Level 2. Another large component of the decrease is the result of sales and settlements of certain corporate and structured securities. Additionally, as a result of our implementation of new authoritative guidance related to the

Table of Contents

accounting for embedded credit derivatives effective July 1, 2010, within the scope of the guidance we reclassified certain securities previously included in fixed maturities, available-for-sale, to fixed maturities, trading. The decrease in separate account assets is primarily a result of real estate sales. These decreases are partially offset by a net increase in fair value of Level 3 instruments related to the implementation of new authoritative guidance related to the accounting for VIEs effective January 1, 2010. As a result of the new guidance, certain previously unconsolidated VIEs were consolidated and certain previously consolidated VIEs were deconsolidated. The fair value of Level 3 assets and liabilities of the newly consolidated and deconsolidated VIEs is primarily included in the net change for fixed maturities, trading; other investments; derivative liabilities and other liabilities.

Investments

We had total consolidated assets as of December 31, 2011, of $148.3 billion, of which $66.2 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, 2011, were predominantly high quality and broadly diversified across asset class, individual credit, industry and geographic location. Asset allocation is determined based on cash flow and the risk/return requirements of our products. As shown in the following table, the major categories of invested assets are fixed maturities and commercial mortgage loans. The remainder is invested in other investments, residential mortgage loans, real estate and equity securities. In addition, policy loans are included in our invested assets.

	December 31, 2011		December 31, 2010	
	Carrying amount	% of total	Carrying amount	% of total
	($ in millions)			
Fixed maturities:				
Public	$ 35,350.3	53%	$ 35,426.8	54%
Private	14,628.1	22	14,329.8	22
Equity securities	481.9	1	486.8	1
Mortgage loans:				
Commercial	9,396.6	14	9,609.0	14
Residential	1,330.6	2	1,516.1	2
Real estate held for sale	44.8		51.9	
Real estate held for investment	1,048.1	2	1,011.6	2
Policy loans	885.1	1	903.9	1
Other investments	2,988.0	5	2,641.6	4
Total invested assets	66,153.5	100%	65,977.5	100%
Cash and cash equivalents	2,833.9		1,877.4	
Total invested assets and cash	$ 68,987.4		$ 67,854.9	

Investment Results

Net Investment Income

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

	For the year ended December 31,						Increase (decrease)			
	2011		2010		2009		2011 vs. 2010		2010 vs. 2009	
	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount
	($ in millions)									
Fixed maturities	5.5%	$ 2,660.9	5.7%	$ 2,794.7	5.6%	$ 2,717.2	(0.2)%	$ (133.8)	0.1%	$ 77.5
Equity securities	3.1	14.9	3.0	14.2	4.2	19.3	0.1	0.7	(1.2)	(5.1)

Mortgage loans commercial	**5.9**	**558.7**	6.0	589.1	5.8	617.7	(0.1)	(30.4)	0.2	(28.6)
Mortgage loans residential	**6.4**	**90.5**	5.2	84.2	4.0	71.2	1.2	6.3	1.2	13.0
Real estate	**6.9**	**74.2**	5.5	57.5	3.7	35.9	1.4	16.7	1.8	21.6
Policy loans	**6.5**	**58.2**	6.7	60.9	6.9	62.0	(0.2)	(2.7)	(0.2)	(1.1)
Cash and cash equivalents	**0.4**	**8.5**	0.4	7.2	0.5	13.0		1.3	(0.1)	(5.8)
Other investments	**(0.3)**	**(7.1)**	(0.9)	(21.8)	(0.9)	(24.0)	0.6	14.7		2.2
Total before investment expenses	**5.1**	**3,458.8**	5.3	3,586.0	5.1	3,512.3	(0.2)	(127.2)	0.2	73.7
Investment expenses	**(0.1)**	**(83.0)**	(0.1)	(89.5)	(0.1)	(111.5)		6.5		22.0
Net investment income	**5.0% $**	**3,375.8**	5.2% $	3,496.5	5.0% $	3,400.8	(0.2)% $	(120.7)	0.2% $	95.7

Table of Contents

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Net investment income decreased due to lower yields and a decrease in average invested assets and cash primarily due to our decision to scale back our investment only business. These decreases were partially offset by higher inflation-based investment returns on average invested assets, most notably fixed maturities and other investments, as a result of higher inflation in Chile and the strengthening of Latin American currencies against the U.S. dollar. Further offsetting the decline in investment income were gains on sales of development real estate properties.

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Net investment income increased primarily due to higher inflation-based investment returns on average invested assets, most notably fixed maturities, related to inflation in Chile during 2010 versus deflation during 2009 and the strengthening of the Chilean peso against the U.S. dollar. In addition, net investment income increased due to gains on sales of equity real estate. These increases were partially offset by a decrease in average invested assets due to our decision to scale back our investment only business.

Net Realized Capital Gains (Losses)

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

	For the year ended December 31,			Increase (decrease)	
	2011	**2010**	**2009**	**2011 vs. 2010**	**2010 vs. 2009**
			(in millions)		
Fixed maturities, available-for-sale credit impairments (1)	**$ (184.0)**	$ (229.0)	$ (372.6)	$ 45.0	$ 143.6
Fixed maturities, available-for-sale other	**1.9**	8.9	52.9	(7.0)	(44.0)
Fixed maturities, trading	**(6.7)**	17.5	49.3	(24.2)	(31.8)
Equity securities credit impairments	**(3.8)**	3.7	(20.5)	(7.5)	24.2
Derivatives and related hedge activities (2)	**(22.4)**	30.8	(11.5)	(53.2)	42.3
Commercial mortgages	**(18.7)**	(53.0)	(120.1)	34.3	67.1
Other gains	**111.4**	29.6	24.2	81.8	5.4
Net realized capital losses	**$ (122.3)**	$ (191.5)	$ (398.3)	$ 69.2	$ 206.8

(1) Includes credit impairments as well as losses on sales of fixed maturities to reduce credit risk, net of realized credit recoveries on the sale of previously impaired securities. Credit gains on sales, excluding associated foreign currency fluctuations that are included in derivatives and related hedge activities, were a net gain of $9.5 million, $15.0 million, and $57.3 million for the years ended December 31, 2011, 2010, and 2009, respectively.

(2) Includes fixed maturities, available-for-sale impairment-related net gain of $0.1 million and net loss of $2.8 million for December 31, 2010 and 2009, respectively.

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

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

Net realized capital losses on fixed maturities, trading increased due to mark-to-market losses versus gains resulting from widening of credit spreads in 2011 and tightening of credit spreads in 2010.

Net realized capital losses on derivatives and related hedge activities increased due to losses versus gains on derivatives not designated as hedging instruments, including credit default swaps due to changes in credit spreads and currency forwards and currency swaps due to changes in exchange rates.

Net realized capital losses on commercial mortgages decreased due to a lower valuation allowance provision in 2011 than in 2010. For additional information, see "U.S. Investment Operations Mortgage Loans Commercial Mortgage Loan Valuation Allowance."

Other net realized capital gains increased due to a realized capital gain of $70.9 million in the second quarter of 2011 resulting from the sale of a portion of our interest in Catalyst Health Solutions, Inc., which is accounted for on the equity method, and a $77.6 million decrease in losses related to the residential mortgage loan loss provision for our bank and trust services business. In addition, other net realized capital gains in 2010 included an $80.1 million gain in the second quarter resulting from the signing of our Shareholders Agreement with Banco pertaining to our Brasilprev joint venture.

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Net realized capital losses on fixed maturities, available-for-sale credit impairments decreased primarily due to lower impairments on corporate securities as a result of improved market conditions and lower net credit losses on sales in 2010 relative to 2009 due to our decision to reduce exposure to BBB rated securities in 2009, partially offset by

Table of Contents

increased impairments on commercial mortgage-backed securities. Net realized capital gains on fixed maturities, available-for-sale -other decreased due to lower gains on sales in 2010.

Net realized capital gains on fixed maturities, trading decreased due to lower mark-to-market gains on these securities resulting from market liquidity impacts and larger credit spread tightening in 2009 compared to 2010.

Net realized capital gains on derivatives and related hedge activities increased due to decreased losses on the GMWB embedded derivatives resulting from changes in the spread reflecting our own creditworthiness. These decreased losses were partially offset by lower gains from fair value hedge ineffectiveness, decreased gains on credit default swaps due to changes in credit spreads and increased mark-to-market losses on interest rate swaps due to changes in interest rates.

Net realized capital losses on commercial mortgages decreased due to a lower valuation allowance provision in 2010 than in 2009. For additional information, see "U.S. Investment Operations Mortgage Loans Commercial Mortgage Loan Valuation Allowance."

Other net realized capital gains included an $80.1 million gain in the second quarter of 2010 resulting from the signing of our Shareholders Agreement with Banco pertaining to our Brasilprev joint venture. This gain was offset by a $64.7 million increase in our residential mortgage loan loss provision for our bank and trust services business, which primarily related to the continued deterioration in our home equity portfolio resulting from sustained economic stress.

U.S. Investment Operations

Of our invested assets, $61.0 billion were held by our U.S. operations as of December 31, 2011. Our U.S. invested assets are managed primarily by our Principal Global Investors segment. Our primary investment objective is to maximize after-tax returns consistent with acceptable risk parameters. We seek to protect policyholders' benefits by optimizing the risk/return relationship on an ongoing basis, through asset/liability matching, reducing the credit risk, avoiding high levels of investments that may be redeemed by the issuer, maintaining sufficiently liquid investments and avoiding undue asset concentrations through diversification. We are exposed to two primary sources of investment risk:

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

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

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

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

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

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

material declines in the issuer's revenues or margins;

significant management or organizational changes;

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.

Table of Contents

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

	Weighted average loan-to-value ratio		**Debt service coverage ratio**	
	December 31, 2011	**December 31, 2010**	**December 31, 2011**	**December 31, 2010**
New mortgages	**45%**	44%	**3.3x**	3.5x
Entire mortgage portfolio	**60%**	66%	**2.0x**	1.8x

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

Overall Composition of U.S. Invested Assets

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

	December 31, 2011		**December 31, 2010**	
	Carrying amount	**% of total**	**Carrying amount**	**% of total**
	($ in millions)			
Fixed maturities:				
Public	**$ 32,081.2**	**53%**	$ 31,956.6	53%
Private	**14,628.1**	**24**	14,329.8	24
Equity securities	**395.9**	**1**	424.1	1
Mortgage loans:				
Commercial	**9,386.0**	**15**	9,599.6	16
Residential	**746.0**	**1**	877.5	1
Real estate held for sale	**36.6**		41.6	
Real estate held for investment	**1,047.3**	**2**	1,010.7	2
Policy loans	**861.6**	**1**	879.7	1
Other investments	**1,783.5**	**3**	1,486.3	2
Total invested assets	**60,966.2**	**100%**	60,605.9	100%
Cash and cash equivalents	**2,741.7**		1,817.2	
Total invested assets and cash	**$ 63,707.9**		$ 62,423.1	

Fixed Maturities

Fixed maturities consist of publicly traded and privately placed bonds, asset-backed securities, redeemable preferred stock and certain nonredeemable preferred stock. Included in the privately placed category as of December 31, 2011 and 2010, were $9.1 billion and $8.7 billion, respectively, of securities subject to certain holding periods and resale restrictions pursuant to Rule 144A of the Securities Act of 1933. Fixed maturities include trading portfolios that support investment strategies that involve the active and frequent purchase and sale of fixed maturities. We held $279.1 million and $274.9 million of these trading securities as of December 31, 2011 and 2010, respectively.

Table of Contents

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

	December 31, 2011		December 31, 2010	
	Carrying amount	% of total	Carrying amount	% of total
	($ in millions)			
U.S. government and agencies	$ 1,004.7	2%	$ 929.1	2%
States and political subdivisions	3,041.1	7	2,826.9	6
Non-U.S. governments	676.1	1	424.2	1
Corporate public	19,194.4	41	19,201.2	41
Corporate private	11,920.7	26	12,065.1	26
Residential mortgage-backed pass-through securities	3,421.3	7	3,379.5	7
Commercial mortgage-backed securities	3,425.7	7	3,847.3	9
Residential collateralized mortgage obligations	1,403.8	3	1,435.4	3
Asset-backed securities	2,621.5	6	2,177.7	5
Total fixed maturities	$ 46,709.3	100%	$ 46,286.4	100%

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

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

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

The international exposure held in our U.S. operation's fixed maturities portfolio was 26% and 27% of total fixed maturities as of December 31, 2011 and 2010, respectively. It is comprised of corporate and foreign government fixed maturities. The following table presents the carrying amount of our international exposure for our U.S. operation's fixed maturities portfolio for the periods indicated.

	December 31, 2011	December 31, 2010
	(in millions)	
European Union	$ 4,132.1	$ 4,212.4
United Kingdom	2,329.5	2,332.4
Australia/New Zealand	1,490.1	1,539.0
Asia-Pacific	1,172.3	1,325.5
Latin America	868.8	790.4
Other countries (1)	2,139.8	2,313.2
Total	$ 12,132.6$	$ 12,512.9

(1) Includes exposure from 14 countries as of December 31, 2011 and 15 countries as of December 31, 2010.

International fixed maturities are determined by the country of domicile of the parent entity of an individual asset. All international fixed maturities held by our U.S. operations are either denominated in U.S. dollars or have been swapped into U.S. dollar equivalents. Our international investments are analyzed internally by country and industry credit investment professionals. We control concentrations using issuer and country level exposure benchmarks, which are based on the credit quality of the issuer and the country. Our investment policy limits total international fixed maturities

Table of Contents

investments and we are within those internal limits. Exposure to Canada is not included in our international exposure. As of December 31, 2011 and 2010, our investments in Canada totaled $1,749.1 million and $1,578.0 million, respectively.

Economic and fiscal conditions in select European countries, including Greece, Ireland, Italy, Portugal and Spain, continue to cause credit concerns particularly to financial institutions and banks with exposure to the European periphery region. Our exposure to the region within our U.S. investment operations fixed maturities portfolio is modest and manageable, representing 2.4% and 2.6% of total fixed maturities as of December 31, 2011 and 2010, respectively. Additionally, we did not hold any sovereign debt issuances of the selected countries and had not bought or sold credit protection on sovereign issuances as of December 31, 2011 and 2010.

The fixed maturities within our U.S. operations portfolio with exposure to the region are primarily corporate credit issuances of large multi-national companies where the majority of revenues are coming from outside the country where the parent company is domiciled. Our experience indicates multinational companies have demonstrated better market price performance and credit ratings stability. As of December 31, 2011, 97% of our total portfolio exposure consists of investment grade bonds with an average price of 97 (carrying value/amortized cost) and a weighted average time to maturity of 5 years.

The following table presents the carrying amount of our European periphery zone fixed maturities exposure for the periods indicated:

	December 31, 2011					
Select European Exposure	**Greece**	**Ireland**	**Italy**	**Portugal**	**Spain**	**Total**
	(in millions)					
Non-Sovereign:						
Financial institutions	$	**$ 62.1**	**$ 53.7**	$	**$ 152.2**	**$ 268.0**
Non-financial institutions	**7.1**	**295.5**	**223.9**	**19.9**	**284.5**	**830.9**
Total	**$ 7.1**	**$ 357.6**	**$ 277.6**	**$ 19.9**	**$ 436.7**	**$ 1,098.9**

	December 31, 2010					
Select European Exposure	**Greece**	**Ireland**	**Italy**	**Portugal**	**Spain**	**Total**
	(in millions)					
Non-Sovereign:						
Financial institutions	$	$ 75.1	$ 52.9	$	$ 133.7	$ 261.7
Non-financial institutions	47.1	337.6	248.4	33.9	260.5	927.5
Total	$ 47.1	$ 412.7	$ 301.3	$ 33.9	$ 394.2	$ 1,189.2

For further details on our International investment operations exposure to these European countries, see "International Investment Operations Fixed Maturities Exposure."

Fixed Maturities Credit Concentrations. One aspect of managing credit risk is through industry, issuer and asset class diversification. Our credit concentrations are managed to established limits. The following table presents our top ten exposures as of December 31, 2011.

	Amortized cost
	(in millions)
Berkshire Hathaway Inc.	**$ 205.6**
AT&T Inc.	**199.3**
General Electric Co.	**192.4**
JPMorgan Chase & Co.	**185.0**
Bank of America Corp. (1)	**182.9**
Credit Suisse Group AG (1)	**171.7**
Wells Fargo & Co. (1)	**171.0**
Verizon Communications Inc.	**154.4**
Republic of Korea	**151.1**
Prudential Financial Inc.	**146.8**
Total top ten exposures	**$ 1,760.2**

(1) Includes actual counterparty exposure.

Fixed Maturities Valuation and Credit Quality. Valuation techniques for the fixed maturities portfolio vary by security type and the availability of market data. The use of different pricing techniques and their assumptions could produce different financial results. See Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 14, Fair Value Measurements" for further details regarding our pricing methodology. Once prices are determined, they are reviewed by analysts for reasonableness based on asset class and observable market data. In addition, investment analysts who are familiar with specific securities review prices for reasonableness through direct interaction with external sources, review of recent trade activity or use of internal models. All fixed maturities placed on

Table of Contents

the "watch list" are periodically analyzed by investment analysts or analysts that focus on troubled securities ("Workout Group"). This group then meets with the Chief Investment Officer and the Portfolio Managers to determine reasonableness of prices. The valuation of impaired bonds for which there is no quoted price is typically based on the present value of the future cash flows expected to be received. Although we believe these values reasonably reflect the fair value of those securities, the key assumptions about risk premiums, performance of underlying collateral (if any) and other market factors involve qualitative and unobservable inputs.

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

However, for loan-backed and structured securities, as defined by the NAIC, the NAIC rating is not always equivalent to an NRSRO rating as described below. For non-agency RMBS, PIMCO Advisors models and assigns the NAIC ratings. For CMBS, Blackrock Solutions undertakes the modeling and assignment of those NAIC ratings. Other loan-backed and structured securities may be subject to an intrinsic price matrix as provided by the NAIC. This may result in a final designation being higher or lower than the NRSRO credit rating.

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

		December 31, 2011			December 31, 2010		
NAIC Rating	**Rating Agency Equivalent**	**Amortized cost**	**Carrying amount**	**% of total carrying amount**	**Amortized cost**	**Carrying amount**	**% of total carrying amount**
				($ in millions)			
1	AAA/AA/A	**$ 26,802.2**	**$ 28,115.1**	**60%**	$ 26,765.7	$ 27,433.1	59%
2	BBB	**14,570.4**	**15,195.9**	**33**	14,445.7	15,027.8	33
3	BB	**2,537.5**	**2,405.8**	**5**	2,599.5	2,460.0	5
4	B	**759.1**	**582.3**	**1**	883.6	739.1	2
5	CCC and lower	**329.4**	**255.5**	**1**	567.1	451.5	1
6	In or near default	**273.4**	**154.7**		329.0	174.9	
	Total fixed maturities	**$ 45,272.0**	**$ 46,709.3**	**100%**	$ 45,590.6	$ 46,286.4	100%

Fixed maturities include 13 securities with an amortized cost of $149.7 million, gross gains of $6.9 million, gross losses of $0.3 million and a carrying amount of $156.3 million as of December 31, 2011, that are still pending a review and assignment of a rating by the SVO. Due to the timing of when fixed maturities are purchased, legal documents are filed and the review by the SVO is completed, there will always be securities in our portfolio that are unrated over a reporting period. In these instances, an equivalent rating is assigned based on our fixed income analyst's assessment.

Commercial Mortgage-Backed Securities and Home Equity Asset-Backed Securities Portfolios. As of December 31, 2011, based on amortized cost, 55% of our CMBS portfolio had ratings of A or higher and 41% was issued in 2005 or before and 15% of our ABS home equity portfolio had ratings of A or higher and 87% was issued in 2005 or before.

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

	December 31, 2011											
	AAA		**AA**		**A**		**BBB**		**BB+ and Below**		**Total**	
	Amortized cost	**Carrying amount**	**Amortized cost**	**Carrying amount**	**Amortized cost**	**Carrying amount**	**Amortized cost**	**Carrying amount**	**Amortized cost**	**Carrying amount**	**Amortized cost**	**Carrying amount**
						(in millions)						
2003 & Prior	**$ 147.0**	**$ 142.3**	**$ 81.3**	**$ 81.4**	**$ 72.2**	**$ 70.2**	**$ 94.6**	**$ 85.2**	**$ 117.8**	**$ 79.9**	**$ 512.9**	**$ 459.0**
2004	**146.5**	**149.6**	**56.8**	**56.9**	**45.2**	**41.6**	**25.1**	**18.8**	**79.4**	**54.7**	**353.0**	**321.6**
2005	**362.0**	**392.4**	**43.5**	**48.0**	**18.3**	**17.1**	**77.5**	**61.6**	**225.0**	**128.7**	**726.3**	**647.8**

2006	**203.4**	**209.2**	**4.8**	**5.6**	**58.6**	**62.9**	**14.6**	**14.5**	**151.9**	**89.9**	**433.3**	**382.1**
2007	**292.2**	**288.9**	**22.8**	**25.1**	**152.7**	**165.2**	**300.8**	**306.6**	**637.2**	**347.8**	**1,405.7**	**1,133.6**
2008			**15.0**	**16.3**	**33.1**	**36.4**			**38.1**	**32.7**	**86.2**	**85.4**
2009	**123.6**	**127.5**	**16.1**	**16.3**							**139.7**	**143.8**
2010	**76.2**	**80.8**	**7.7**	**7.6**							**83.9**	**88.4**
2011	**165.3**	**164.0**									**165.3**	**164.0**
Total	**$ 1,516.2**	**$ 1,554.7**	**$ 248.0**	**$ 257.2**	**$ 380.1**	**$ 393.4**	**$ 512.6**	**$ 486.7**	**$ 1,249.4**	**$ 733.7**	**$ 3,906.3**	**$ 3,425.7**

66

Table of Contents

December 31, 2010

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

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

December 31, 2011

	AAA Amortized cost	AAA Carrying amount	AA Amortized cost	AA Carrying amount	A Amortized cost	A Carrying amount	BBB Amortized cost	BBB Carrying amount	BB+ and Below Amortized cost	BB+ and Below Carrying amount	Total Amortized cost	Total Carrying amount
	(in millions)											
2003 & Prior	**$ 12.3**	**$ 12.3**	**$ 7.3**	**$ 7.0**	**$ 12.7**	**$ 12.0**	**$ 61.2**	**$ 54.8**	**$ 102.7**	**$ 77.1**	**$ 196.2**	**$ 163.2**
2004	**1.5**	**1.4**	**12.6**	**11.9**	**8.4**	**7.8**	**2.1**	**2.1**	**47.1**	**38.3**	**71.7**	**61.5**
2005			**3.0**	**3.1**					**67.8**	**43.3**	**70.8**	**46.4**
2006									**14.9**	**9.5**	**14.9**	**9.5**
2007									**37.2**	**27.8**	**37.2**	**27.8**
Total	**$ 13.8**	**$ 13.7**	**$ 22.9**	**$ 22.0**	**$ 21.1**	**$ 19.8**	**$ 63.3**	**$ 56.9**	**$ 269.7**	**$ 196.0**	**$ 390.8**	**$ 308.4**

December 31, 2010

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

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

Table of Contents

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

	December 31, 2011	December 31, 2010
	($ in millions)	
Total fixed maturities (public and private)	**$ 46,709.3**	$ 46,286.4
Problem fixed maturities (1)	**$ 343.5**	$ 378.7
Potential problem fixed maturities	**166.3**	237.6
Restructured problem fixed maturities	**14.6**	17.4
Total problem, potential problem and restructured fixed maturities	**$ 524.4**	$ 633.7
Total problem, potential problem and restructured fixed maturities as a percent of total fixed maturities	**1.12%**	1.37%

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

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

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

We consider relevant facts and circumstances in evaluating whether a credit or interest-related impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events; (4) for structured securities, the adequacy of the expected cash flows and (5) our intent to sell the security or whether it is more likely than not we will be required to sell the security before recovery of its amortized cost which, in some cases, may extend to maturity. To the extent we determine that a security is deemed to be other than temporarily impaired, an impairment loss is recognized. For additional details, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 4, Investments."

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

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

The net realized loss relating to other-than-temporary credit impairments and credit related sales of fixed maturities was $186.7 million, $244.7 million, and $428.5 million for the years ended December 31, 2011, 2010, and 2009, respectively.

Table of Contents

Fixed Maturities Available-for-Sale

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

	December 31, 2011			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Carrying amount
	(in millions)			
Finance Banking	$ 4,520.7	$ 79.9	$ 445.5	$ 4,155.1
Finance Brokerage	381.0	15.4	6.7	389.7
Finance Finance Companies	216.2	8.9	4.7	220.4
Finance Financial Other	532.4	55.5	1.1	586.8
Finance Insurance	2,966.3	227.2	73.0	3,120.5
Finance REITS	1,015.2	28.3	22.0	1,021.5
Industrial Basic Industry	1,656.6	135.3	5.4	1,786.5
Industrial Capital Goods	2,133.0	146.8	14.3	2,265.5
Industrial Communications	2,033.2	179.9	23.8	2,189.3
Industrial Consumer Cyclical	1,606.7	130.5	12.4	1,724.8
Industrial Consumer Non-Cyclical	3,084.0	286.3	3.7	3,366.6
Industrial Energy	1,978.4	220.9	1.2	2,198.1
Industrial Other	596.1	32.5	3.9	624.7
Industrial Technology	851.3	57.7	9.3	899.7
Industrial Transportation	626.2	45.7	10.3	661.6
Utility Electric	2,709.6	276.0	18.9	2,966.7
Utility Natural Gas	1,034.2	100.2	1.8	1,132.6
Utility Other	197.1	20.1		217.2
FDIC guaranteed	80.0	0.6		80.6
Government guaranteed	1,219.0	107.8	7.8	1,319.0
Total corporate securities	29,437.2	2,155.5	665.8	30,926.9
Residential mortgage-backed pass-through securities	3,130.8	185.6	0.7	3,315.7
Commercial mortgage-backed securities	3,894.3	117.0	597.6	3,413.7
Residential collateralized mortgage obligations	1,408.1	32.0	51.5	1,388.6
Asset-backed securities Home equity (1)	390.8	0.2	82.6	308.4
Asset-backed securities All other	1,808.0	68.1	2.9	1,873.2
Collateralized debt obligations Credit	82.8		34.4	48.4
Collateralized debt obligations CMBS	98.7	1.6	18.5	81.8
Collateralized debt obligations Loans	203.2	0.3	8.8	194.7
Collateralized debt obligations ABS	15.0		1.1	13.9
Total mortgage-backed and other asset-backed securities	11,031.7	404.8	798.1	10,638.4
U.S. government and agencies	772.3	32.8		805.1
States and political subdivisions	2,670.0	218.2	5.5	2,882.7
Non-U.S. governments	580.7	96.3	0.9	676.1
Total fixed maturities, available-for-sale	$ 44,491.9	$ 2,907.6	$ 1,470.3	$ 45,929.2

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

Table of Contents

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

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

Of the $1,470.3 million in gross unrealized losses as of December 31, 2011, there were $7.1 million in losses attributed to securities scheduled to mature in one year or less, $113.6 million attributed to securities scheduled to mature between one to five years, $79.0 million attributed to securities scheduled to mature between five to ten years, $472.5 million attributed to securities scheduled to mature after ten years and $798.1 million related to mortgage-backed and other ABS that are not classified by maturity year. As of December 31, 2011, we were in a $1,437.3 million net unrealized gain position as compared to a $695.8 million net unrealized gain position as of December 31, 2010. Of the $741.5 million increase in net unrealized gains for the year ended December 31, 2011, an approximate $2.2 billion net unrealized gain can be attributed to an approximate 98 basis points decrease in interest rates offset in part by net unrealized losses related to other market factors, primarily from widening of credit spreads.

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

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

Table of Contents

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

	December 31, 2011				December 31, 2010			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Carrying amount	Amortized cost	Gross unrealized gains	Gross unrealized losses	Carrying amount
	(in millions)							
Investment grade:								
Public	$ 28,497.9	$ 1,989.8	$ 435.0	$ 30,052.7	$ 28,496.5	$ 1,429.0	$ 394.5	$ 29,531.0
Private	12,298.2	757.4	373.8	12,681.8	12,071.9	621.4	406.4	12,286.9
Below investment grade:								
Public	1,834.4	21.3	365.1	1,490.6	2,087.8	39.1	305.3	1,821.6
Private	1,861.4	139.1	296.4	1,704.1	2,052.5	51.8	339.3	1,765.0
Total fixed maturities, available-for-sale	$ 44,491.9	$ 2,907.6	$ 1,470.3	$ 45,929.2	$ 44,708.7	$ 2,141.3	$ 1,445.5	$ 45,404.5

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

	December 31, 2011					
	Public		Private		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	$ 897.5	$ 14.1	$ 472.0	$ 4.9	$ 1,369.5	$ 19.0
Greater than three to six months	1,022.9	33.7	747.1	24.0	1,770.0	57.7
Greater than six to nine months	420.3	40.7	337.4	20.2	757.7	60.9
Greater than nine to twelve months	61.8	5.5	65.2	3.4	127.0	8.9
Greater than twelve to twenty-four months	135.0	15.8	184.5	20.5	319.5	36.3
Greater than twenty-four to thirty-six months	65.7	16.3	30.0	5.5	95.7	21.8
Greater than thirty-six months	1,122.5	308.9	1,138.0	295.3	2,260.5	604.2
Total fixed maturities, available-for-sale	$ 3,725.7	$ 435.0	$ 2,974.2	$ 373.8	$ 6,699.9	$ 808.8

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

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

	December 31, 2011					
	Public		Private		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	$ 123.4	$ 3.6	$ 72.3	$ 6.3	$ 195.7	$ 9.9
Greater than three to six months	71.3	8.1	165.4	12.4	236.7	20.5
Greater than six to nine months	74.3	11.5	30.8	1.9	105.1	13.4
Greater than nine to twelve months	16.9	9.5	29.5	1.6	46.4	11.1
Greater than twelve to twenty-four months	42.2	11.8	18.9	4.4	61.1	16.2
Greater than twenty-four to thirty-six months	17.9	3.6	1.3	0.3	19.2	3.9
Greater than thirty-six months	693.0	317.0	483.5	269.5	1,176.5	586.5
Total fixed maturities, available-for-sale	$ 1,039.0	$ 365.1	$ 801.7	$ 296.4	$ 1,840.7	$ 661.5

Table of Contents

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

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

	December 31, 2011					
	Problem, potential problem, and restructured		All other fixed maturity securities		Total	
	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses	Carrying amount	Gross unrealized losses
	(in millions)					
Three months or less	**$ 42.4**	**$ 14.0**	**$ 231.7**	**$ 75.5**	**$ 274.1**	**$ 89.5**
Greater than three to six months	**74.4**	**32.2**	**587.3**	**263.9**	**661.7**	**296.1**
Greater than six to nine months	**18.2**	**11.6**	**77.6**	**47.2**	**95.8**	**58.8**
Greater than nine to twelve months	**3.5**	**1.6**	**6.9**	**8.5**	**10.4**	**10.1**
Greater than twelve months	**171.9**	**262.4**	**452.8**	**387.6**	**624.7**	**650.0**
Total fixed maturities, available-for-sale	**$ 310.4**	**$ 321.8**	**$ 1,356.3**	**$ 782.7**	**$ 1,666.7**	**$ 1,104.5**

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

Mortgage Loans

Mortgage loans consist of commercial mortgage loans on real estate and residential mortgage loans. The carrying amount of our commercial mortgage loan portfolio was $9,386.0 million and $9,599.6 million as of December 31, 2011 and 2010, respectively. The carrying amount of our residential mortgage loan portfolio was $746.0 million and $877.5 million as of December 31, 2011 and 2010, respectively.

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

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

- providing strong risk-adjusted relative value in comparison to other investment alternatives;
- enhancing total returns and
- providing strategic portfolio diversification.

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

Table of Contents

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

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

The typical borrower in our commercial loan portfolio is a single purpose entity or single asset entity. As of both December 31, 2011 and 2010, 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 975 and 1,033 as of December 31, 2011 and 2010, respectively. The average loan size of our commercial mortgage portfolio was $9.7 million and $9.4 million as of December 31, 2011 and 2010, respectively.

Commercial Mortgage Loan Credit Monitoring. For further details on monitoring and management of our commercial mortgage loan portfolio, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 4, Investments Mortgage Loan Credit Monitoring."

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

There was a significant increase in the level of problem, potential problem, and restructured commercial mortgages during 2009 due to the impact of the U.S. recession on commercial real estate, peaking at year-end 2009. There was a decrease in the level of problem, potential problem and restructured commercial mortgages during 2011 primarily due to loan payoffs, foreclosures, and improvement in collateral occupancies and values. The South Atlantic, Pacific, and East North Central regions accounted for over 90% of the problem, potential problem and restructured commercial mortgages as of December 31, 2011. The South Atlantic region accounted for the majority of the problem, potential problem, and restructured commercial mortgages as of December 31, 2010. Office and apartment properties accounted for 60% of the problem, potential problem and restructured commercial mortgages as of December 31, 2011. Apartments and industrial properties accounted for over half of the problem, potential problem and restructured commercial mortgages as of December 31, 2010.

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, 2011	December 31, 2010
	($ in millions)	
Total commercial mortgages	**$ 9,386.0**	$ 9,599.6
Problem commercial mortgages (1)	**$ 112.7**	$ 35.7
Potential problem commercial mortgages	**152.8**	317.7
Restructured problem commercial mortgages	**7.5**	7.5
Total problem, potential problem and restructured commercial mortgages	**$ 273.0**	$ 360.9
Total problem, potential problem and restructured commercial mortgages as a percent of total commercial mortgages	**2.91%**	3.76%

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

Commercial Mortgage Loan Valuation Allowance. The valuation allowance for commercial mortgage loans includes loan specific reserves for loans that are deemed to be impaired as well as reserves for pools of loans with similar characteristics where a property risk or market specific risk has not been identified but for which we anticipate a loss may occur. For further details on the commercial mortgage valuation allowance, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 4, Investments Mortgage Loan Valuation Allowance."

The valuation allowance decreased $15.8 million for the year ended December 31, 2011, and decreased $51.9 million for the year ended December 31, 2010. The decrease in the level of valuation allowance during 2011 was related to the

Table of Contents

same market factors as those causing the decrease in the level of problem, potential problem and restructured commercial mortgages during the year ended December 31, 2011. The decrease in the level of valuation allowance during 2010 was primarily related to loan write downs, payoffs and loan sales and the related release of valuation allowance, which is partially offset by current period provisions. The South Atlantic region accounted for the highest level of reserves at both December 31, 2011 and 2010.

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

	December 31, 2011	December 31, 2010
	($ in millions)	
Balance, beginning of period	**$ 80.6**	$ 132.5
Provision	**17.0**	54.1
Charge-offs	**(32.9)**	(106.0)
Recoveries	**0.1**	
Balance, end of period	**$ 64.8**	$ 80.6
Valuation allowance as % of carrying value before reserves	**0.69%**	0.83%

Residential Mortgage Loans. The residential mortgage loan portfolio is composed of home equity mortgages with an amortized cost of $611.0 million and $719.3 million and first lien mortgages with an amortized cost of $171.0 million and $195.9 million as of December 31, 2011 and 2010, respectively, primarily held by our Bank and Trust Services business. The home equity loans are generally second lien mortgages made up of closed-end loans and lines of credit. Non-performing residential mortgage loans, which are defined as loans 90 days or greater delinquent plus non-accrual loans, totaled $24.0 million as of both December 31, 2011 and 2010. We establish the residential mortgage loan valuation allowance at levels considered adequate to absorb probable losses within the portfolio based on management's evaluation of the size and current risk characteristics of the portfolio. Such evaluation considers numerous factors, including, but not limited to net charge-off trends, loss forecasts, collateral values, geographic location, borrower credit scores, delinquency rates, industry condition and economic trends. The changes in the valuation allowance are reported in net realized capital gains (losses) on our consolidated statements of operations.

Our residential mortgage loan portfolio, and in particular our home equity loan portfolio, experienced an increase in loss severity from sustained elevated levels of unemployment along with continued depressed collateral values in 2010. While these factors continued to drive charge-offs in 2011, losses declined from the prior year due to declining loan balances. The following table represents our residential mortgage valuation allowance for the periods indicated.

	December 31, 2011	December 31, 2010
	($ in millions)	
Balance, beginning of period	**$ 37.7**	$ 28.7
Provision	**28.5**	97.6
Charge-offs	**(33.4)**	(89.7)
Recoveries	**3.2**	1.1
Balance, end of period	**$ 36.0**	$ 37.7
Valuation allowance as % of carrying value before reserves	**4.6%**	4.1%

Real Estate

Real estate consists primarily of commercial equity real estate. As of December 31, 2011 and 2010, the carrying amount of our equity real estate investment was $1,083.9 million, or 2%, and $1,052.3 million, or 2%, of U.S. invested assets, respectively. Our commercial equity real estate is held in the form of wholly owned real estate, real estate acquired upon foreclosure of commercial mortgage loans and majority owned interests in real estate joint ventures.

Equity real estate is categorized as either "real estate held for investment" or "real estate held for sale." Real estate held for investment totaled $1,047.3 million and $1,010.7 million as of December 31, 2011 and 2010, respectively. The carrying value of real estate held for investment is generally adjusted for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Such impairment adjustments are recorded as net realized losses and, accordingly, are reflected in our consolidated results of operations. For the year ended December 31, 2011 and 2010, there were no such impairment adjustments.

The carrying amount of real estate held for sale was $36.6 million and $41.6 million as of December 31, 2011 and 2010, respectively. There were no valuation allowances as of December 31, 2011 or 2010. Once we identify a real estate property to be sold and commence a plan for marketing the property, we classify the property as held for sale. We establish a valuation allowance subject to periodic revisions, if necessary, to adjust the carrying value of the property to reflect the lower of its current carrying value or the fair value, less associated selling costs.

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

Table of Contents

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, 2011. By property type, there is a concentration in office, industrial and retail that represented approximately 77% of the equity real estate portfolio as of December 31, 2011.

Other Investments

Our other investments totaled $1,783.5 million as of December 31, 2011, compared to $1,486.3 million as of December 31, 2010. Derivative assets accounted for $1,156.5 million and $1,058.5 million in other investments as of December 31, 2011 and 2010, respectively. The remaining invested assets primarily include equity method investments, which include real estate properties owned jointly with venture partners and operated by the partners.

International Investment Operations

Of our invested assets, $5.2 billion were held by our Principal International segment as of December 31, 2011. The assets are managed by either our Principal Global Investors segment or by the local Principal International affiliate. Due to the regulatory constraints in each country, each company maintains its own investment policies. As shown in the following table, the major categories of international invested assets as of December 31, 2011 and 2010, were fixed maturities, other investments, residential mortgage loans and equity securities. In addition, policy loans are included in our invested assets. The following table excludes invested assets of the separate accounts.

	December 31, 2011		December 31, 2010	
	Carrying amount	% of total	Carrying amount	% of total
		($ in millions)		
Fixed maturities Public	$ 3,269.1	63%	$ 3,470.2	65%
Equity securities	86.0	2	62.7	1
Mortgage loans:				
Commercial	10.6		9.4	
Residential	584.6	11	638.6	12
Real estate held for sale	8.2		10.3	
Real estate held for investment	0.8		0.9	
Policy loans	23.5	1	24.2	
Other investments	1,204.5	23	1,155.3	22
Total invested assets	5,187.3	100%	5,371.6	100%
Cash and cash equivalents	92.2		60.2	
Total invested assets and cash	$ 5,279.5		$ 5,431.8	

Investments in equity method subsidiaries and direct financing leases accounted for $669.7 million and $507.5 million, respectively, of other investments as of December 31, 2011. Investments in equity method subsidiaries and direct financing leases accounted for $667.0 million and $443.1 million, respectively, of other investments as of December 31, 2010. The remaining other investments as of both December 31, 2011 and 2010, are primarily related to derivative assets and seed money investments.

Fixed Maturities Exposure

Economic and fiscal conditions in select European countries, including Greece, Ireland, Italy, Portugal and Spain, continue to cause credit concerns particularly to financial institutions and banks with exposure to the European periphery region. Our exposure to the region within our International investment operations fixed maturities portfolio is manageable, representing 7.7% and 8.8% of our total International invested assets as of December 31, 2011 and 2010, respectively. Portfolio holdings with exposure to this region consist of fixed maturities issued in the same countries as our International operations by local subsidiaries of the European parent. Nearly all of the exposure is to bonds issued in Chile. In addition, we did not hold any sovereign debt issuances of the selected countries and had not bought or sold credit protection on sovereign issuances as of December 31, 2011 and 2010.

Financial sector exposure is to local subsidiary banks, subject to local capital requirements and banking regulation. The current financial exposure carries an average AAA local rating from S&P and the average time to maturity is 19 years. Non-financial sector exposure consists primarily of infrastructure bonds, which are backed by the project itself, often with minimum revenue guarantees from the government. The current non-financial exposure carries an average AA local rating from S&P. The current Italian exposure has an average time to maturity of 15 years. In addition, the current Spanish exposure has an average time to maturity of 14 years. As of December 31, 2011, our total portfolio exposure had an average price of 107 (carrying value/amortized cost).

Table of Contents

The following table presents the carrying amount of our European periphery zone fixed maturities exposure for the periods indicated.

Select European Exposure	December 31, 2011 Italy	December 31, 2011 Spain	December 31, 2011 Total	December 31, 2010 Italy	December 31, 2010 Spain	December 31, 2010 Total
			(in millions)			
Non-Sovereign:						
Financial institutions	**$**	**$ 241.5**	**$ 241.5**	$	$ 286.4	$ 286.4
Non-financial institutions	**52.5**	**112.4**	**164.9**	53.3	137.0	190.3
Total	**$ 52.5**	**$ 353.9**	**$ 406.4**	$ 53.3	$ 423.4	$ 476.7

For further details on our U.S. investment operations exposure to these European countries, see "U.S. Investment Operations Fixed Maturities."

Table of Contents

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.

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

- 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, as of December 31, 2011, approximately $11.3 billion, or 98%, of our institutional GICs and funding agreements cannot be redeemed by contractholders prior to maturity.

We are also exposed to interest rate risk based upon the discount rate assumption used for purposes of valuing our pension and other post retirement benefit obligations. 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 Operations 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 Retirement and Investor Services segment. We actively manage the duration of assets and liabilities in these products by minimizing the difference between the two.

As of December 31, 2011, the difference between the asset and liability durations on our primary duration-managed portfolio was -0.35, as compared to -0.28 as of December 31, 2010. This duration gap indicates that, as of December 31, 2011, the sensitivity of the fair value of our assets to interest rate movements is less than that of the fair value of our liabilities. Our goal is to minimize the duration gap. Currently, our guidelines indicate that total duration gaps between the asset and liability portfolios should be within +/-0.25. As of December 31, 2011, the mismatch exceeds our duration gap guideline due to temporary asset and liability spread mismatches. However, our cash flow studies reflect our general practice to hold assets and liabilities to maturity and indicate that the interest rate risk is sufficiently managed. The value of the assets in this portfolio was $26,811.6 million and $26,601.9 million as of December 31, 2011 and 2010, respectively.

Duration-Monitored. For products such as whole life insurance and term life insurance that are less sensitive to interest rate risk, and for other products such as individual fixed deferred annuities, we manage interest rate risk based on a modeling process that considers the target average life, maturities, crediting rates and assumptions of policyholder behavior. As of December 31, 2011, the weighted-average difference between the asset and liability durations on these portfolios was -3.03, as compared to -1.54 as of December 31, 2010. This duration gap indicates that, as of December 31, 2011, the sensitivity of the fair value of our assets to interest rate movements is less than that of the fair value of our liabilities. We attempt to monitor this duration gap consistent with our overall risk/reward tolerances. The

Table of Contents

value of the assets in these portfolios was $25,650.8 million and $24,720.0 million as of December 31, 2011 and 2010, respectively.

Non Duration-Managed. We also have a block of participating general account pension business that passes most of the actual investment performance of the assets to the customer. The investment strategy of this block is to maximize investment return to the customer on a "best efforts" basis, and there is little or no attempt to manage the duration of this portfolio since there is little or no interest rate risk. The value of the assets in these portfolios was $5,400.0 million and $5,167.8 million as of December 31, 2011 and 2010, respectively.

Using the assumptions and data in effect as of December 31, 2011, we estimate that a 100 basis point immediate, parallel increase in interest rates increases the net fair value of our portfolio by approximately $871.9 million, compared with an estimated $455.4 million increase as of December 31, 2010. The following table details the estimated changes by risk management strategy. The table also gives the weighted-average duration of the asset portfolio for each category, and the net duration gap (i.e., the weighted-average difference between the asset and liability durations).

	December 31, 2011			
Risk Management Strategy	**Value of total assets**	**Duration of assets**	**Net duration gap**	**Net fair value change**
	(in millions)			*(in millions)*
Primary duration-managed	**$ 26,811.6**	**3.59**	**(0.35)**	**$ 93.8**
Duration-monitored	**25,650.8**	**4.18**	**(3.03)**	**778.1**
Non duration-managed	**5,400.0**	**3.97**	**N/A**	**N/A**
Total	**$ 57,862.4**			**$ 871.9**

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 Operations Critical Accounting Policies and Estimates Valuation and Impairment of Fixed Income Investments" for additional discussion of the impact interest rate increases would have on fixed maturities, available-for-sale.

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

The aggregate fair value of long-term debt, excluding accrued interest, was $1,750.7 million and $1,756.3 million, as of December 31, 2011 and 2010, respectively. As of December 31, 2011, a 100 basis point immediate, parallel decrease in interest rates would increase the fair value of debt by approximately $129.1 million, as compared to an estimated $143.1 million increase as of December 31, 2010. As of December 31, 2011, a 100 basis point immediate, parallel increase in interest rates would decrease the fair value of debt by approximately $118.1 million, as compared to an estimated $128.4 million decrease as of December 31, 2010. Debt is not recorded at fair value on the consolidated statements of financial position.

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

For additional information regarding our debt, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 9, Debt."

Use of Derivatives to Manage Interest Rate Risk. We use or have previously used various derivative financial instruments to manage our exposure to fluctuations in interest rates, including interest rate swaps, interest rate collars, swaptions, futures 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. We use interest rate collars to manage interest rate risk related to guaranteed minimum interest rate liabilities in our individual annuities contracts. We purchase swaptions to offset existing exposures. Occasionally, we have sold a callable investment-type agreement and used written interest rate swaptions to transform the callable liability into a fixed term liability.

Table of Contents

Derivatives in our portfolio with interest rate sensitivity were in a net liability position with a fair value of $424.6 million and $309.9 million as of December 31, 2011 and 2010, respectively. The following table shows the interest rate sensitivity of our derivatives measured in terms of fair value. These exposures will change as a result of ongoing portfolio and risk management activities.

	December 31, 2011				
			Fair value (no accrued interest)		
	Notional amount	Weighted average term (years) (1)	-100 basis point change	No change	+100 basis point change
	($ in millions)				
Interest rate swaps	$ 19,498.3	5.18	$ (408.9)	$ (459.8)	$ (501.3)
Futures (2)	522.0	0.25	(35.9)	(3.3)	29.1
Interest rate collars	500.0	11.15	70.5	38.5	20.2
Swaptions	68.5	0.16			
Total	$ 20,588.8		$ (374.3)	$ (424.6)	$ (452.0)

(1) Based on maturity date.

(2) We use U.S. Treasury futures to manage our over/under commitment position, and our position in these contracts changes daily.

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

Foreign Currency Risk

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from foreign currency-denominated funding agreements issued to nonqualified institutional investors in the international market, foreign currency-denominated fixed maturities and our international operations.

We estimate that as of December 31, 2011, a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we are exposed would result in no material change to the net fair value of our foreign currency denominated instruments identified above because we effectively hedge foreign currency denominated instruments to minimize exchange rate impacts, which is consistent with our estimate as of December 31, 2010. However, fluctuations in foreign currency exchange rates do affect the translation of operating earnings and equity of our international operations into our consolidated financial statements.

For our Principal International segment, we estimate that a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we were exposed would have resulted in a $171.6 million, or 10%, reduction in the total equity excluding noncontrolling interests of our international operations as of December 31, 2011, as compared to an estimated $161.6 million, or 10%, reduction as of December 31, 2010. We estimate that a 10% unfavorable change in the average foreign currency exchange rates to which we were exposed through our international operations would have resulted in a $16.9 million, or 11%, reduction in the operating earnings of our international operations for the year ended December 31, 2011, as compared to an estimated $14.8 million, or 11%, reduction for the year ended December 31, 2010.

The selection of a 10% immediate unfavorable change in all currency exchange rates should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event. These exposures will change as a result of a change in the size and mix of our foreign operations.

Use of Derivatives to Manage Foreign Currency Risk. The foreign currency risk on funding agreements and fixed maturities is mitigated by using currency swaps that swap the foreign currency interest and principal payments to our functional currency. The notional amount of our currency swap agreements associated with foreign-denominated liabilities was $2,454.3 million and $2,995.4 million as of

December 31, 2011 and 2010, respectively. The notional amount of our currency swap agreements associated with foreign-denominated fixed maturities was $1,390.1 million and $1,558.5 million as of December 31, 2011 and 2010, 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 $75.4 million and $61.3 million as of December 31, 2011 and 2010, respectively, which were used to swap cash flows on U.S. dollar-denominated bonds to a local currency. Chile also utilized currency forwards with a notional amount of $147.3 million and $72.3 million as of December 31, 2011 and 2010, respectively, in order to mitigate currency exposure related to bonds denominated in currencies other than Chilean pesos.

Table of Contents

Additionally, from time to time we take measures to hedge our net equity investments in our foreign subsidiaries from currency risks. There were no outstanding net equity investment hedges in 2011 or 2010.

Equity Risk

Equity risk is the risk that we will incur economic losses due to adverse fluctuations in a particular common stock. As of December 31, 2011 and 2010, the fair value of our equity securities was $481.9 million and $486.8 million, respectively. As of December 31, 2011, a 10% decline in the value of the equity securities would result in an unrealized loss of $48.2 million, as compared to an estimated unrealized loss of $48.7 million as of December 31, 2010.

We are also exposed to the risk that asset-based fees decrease as a result of declines in assets under management due to change in investment prices and the risk that asset management fees calculated by reference to performance could be lower. We estimate that an immediate 10% decline in the Standard & Poor's index, followed by a 2% per quarter increase would reduce our annual operating earnings by approximately four to six percent. The risk of decreased asset-based and asset management fees could also impact our estimates of total gross profits used as a basis for amortizing deferred policy acquisition costs and other actuarial balances. For further discussion, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations 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 contacts 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 Operations Critical Accounting Policies and Estimates Benefit Plans."

Use of Derivatives to Manage Equity Risk. We economically hedge the fixed deferred annuity product, where the interest credited is linked to an external equity index, by purchasing options that match the product's profile. We economically hedge the GMWB exposure, which includes interest rate risk and equity risk, using futures, options and interest rate swaps. We economically hedge the investment contract exposure to an external equity index using equity call options.

The fair value of both the GMWB embedded derivative and associated hedging instruments are sensitive to financial market conditions and the variance related to the change in fair value of these items for a given period is largely dependent on market conditions at the end of the period. We recognized a pre-tax gain (loss) on the derivatives used to economically hedge our GMWB market risk of $166.6 million and $(21.2) million for the years ended December 31, 2011 and 2010, respectively. We recognized a pre-tax gain (loss) on the change in fair value of the GMWB embedded derivative that is primarily related to market risk impacts (excluding spread reflecting our own creditworthiness), of $(227.1) million and $16.2 million for the years ended December 31, 2011 and 2010, respectively. Additionally, we recognized a pre-tax gain (loss) on the change in value of the GMWB liability related to other factors, of $95.6 million and $(13.7) million for the years ended December 31, 2011 and 2010, respectively, primarily related to incorporating a spread reflecting our own creditworthiness. We reflect the actual and expected changes in value of the GMWB embedded derivative and the associated hedging instruments in our estimated gross profits, which resulted in a pre-tax increase in DPAC amortization of $37.7 million and $9.4 million for the years ended December 31, 2011 and 2010, respectively.

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 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 5, Derivative Financial Instruments" under the caption, "Credit Derivatives Sold."

We economically hedged credit exposure in our portfolio by purchasing credit default swaps with a notional amount of $607.0 million and $374.5 million as of December 31, 2011 and 2010, respectively. We had credit exposure through credit default swaps with a notional amount of $147.4 million and $140.0 million as of December 31, 2011 and 2010,

Table of Contents

respectively, by investing in various tranches of synthetic collateralized debt obligations. In addition, we sold credit default swaps creating replicated assets with a notional amount of $775.9 million and $967.9 million as of December 31, 2011 and 2010, respectively.

Derivative Counterparty Risk

In conjunction with our use of derivatives, we are exposed to counterparty risk, or the risk that the counterparty fails to perform the terms of the derivative contract. We actively manage this risk by:

- obtaining approval of all new counterparties by the Investment Committee;
- establishing exposure limits that take into account non-derivative exposure we have with the counterparty as well as derivative exposure;
- performing similar credit analysis prior to approval on each derivatives counterparty that we do when lending money on a long-term basis;
- diversifying our risk across numerous approved counterparties;
- implementing credit support annex (collateral) agreements ("CSAs") with majority of counterparties to further limit counterparty exposures, which provide for netting of exposures;
- limiting exposure to A+ credit or better for counterparties without CSAs;
- conducting stress-test analysis to determine the maximum exposure created during the life of a prospective transaction and
- daily monitoring of counterparty credit ratings, exposures and associated collateral levels.

We believe the risk of incurring losses due to nonperformance by our counterparties is manageable. For further information on derivatives, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 5, Derivative Financial Instruments."

Based on our accounting policy, our disclosed exposure measures the fair value of derivatives that have become favorable to us and, therefore, is a combined credit exposure if all of the involved counterparties failed to fulfill their obligations. In the hypothetical scenario where all of our counterparties fail to fulfill their obligations, our exposure would be $1,245.1 million; however, including collateral received our exposure would be reduced to $1,008.1 million at December 31, 2011. For further information on derivative exposure, see Item 8. "Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 5, Derivative Financial Instruments" under the caption, "Exposure."

We manage our exposure on a net basis, whereby we net positive and negative exposures for each counterparty with agreements in place. Netting positive and negative exposures would yield an exposure of $276.7 million, which is reduced to $39.7 million with pledged collateral at December 31, 2011. As of December 31, 2011, we held total collateral of $237.0 million in the form of cash and securities and we posted $502.4 million in cash and securities as collateral to our counterparties. We have not incurred any material losses on derivative financial instruments due to counterparty nonperformance. As a result of our management of our counterparty risk and the collateralization of our derivative portfolio, any deterioration in our derivative counterparties' credit would not materially impact our financial statements as of December 31, 2011.

Table of Contents

Item 8. Financial Statements and Supplementary Data

Table of Contents

Report of Independent Registered Public Accounting Firm
on Internal Control Over Financial Reporting

The Board of Directors and Stockholders
Principal Financial Group, Inc.

We have audited Principal Financial Group, Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("the COSO criteria"). Management of Principal Financial Group, Inc. ("the Company") is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Principal Financial Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial position of Principal Financial Group, Inc. as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2011, and our report dated February 15, 2012, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Des Moines, Iowa
February 15, 2012

Table of Contents

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Principal Financial Group, Inc.

We have audited the accompanying consolidated statements of financial position of Principal Financial Group, Inc. ("the Company") as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Principal Financial Group, Inc. at December 31, 2011 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, in response to new accounting standards, the Company changed its methods of accounting for credit derivatives embedded in beneficial interests in securitized financial assets effective July 1, 2010; for variable interest entities effective January 1, 2010 and for other-than-temporary impairments on debt securities and for the treatment of noncontrolling interests effective January 1, 2009.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control   Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 15, 2012, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Des Moines, Iowa
February 15, 2012

Table of Contents

Principal Financial Group, Inc.

Consolidated Statements of Financial Position

	December 31, 2011	December 31, 2010
	(in millions)	
Assets		
Fixed maturities, available-for-sale (2011 and 2010 include $214.2 million and $257.9 million related to consolidated variable interest entities)	**$ 49,006.7**	$ 48,636.3
Fixed maturities, trading (2011 and 2010 include $132.4 million and $131.4 million related to consolidated variable interest entities)	**971.7**	1,120.3
Equity securities, available-for-sale	**77.1**	169.9
Equity securities, trading (2011 and 2010 include $207.6 million and $158.6 million related to consolidated variable interest entities)	**404.8**	316.9
Mortgage loans	**10,727.2**	11,125.1
Real estate	**1,092.9**	1,063.5
Policy loans	**885.1**	903.9
Other investments (2011 and 2010 include $97.8 million and $128.7 million related to consolidated variable interest entities, of which $97.5 million and $128.3 million are measured at fair value under the fair value option)	**2,988.0**	2,641.6
Total investments	**66,153.5**	65,977.5
Cash and cash equivalents (2011 and 2010 include $317.7 million and $100.0 million related to consolidated variable interest entities)	**2,833.9**	1,877.4
Accrued investment income	**615.2**	666.1
Premiums due and other receivables	**1,245.2**	1,063.0
Deferred policy acquisition costs	**3,313.5**	3,529.8
Property and equipment	**457.2**	458.7
Goodwill	**482.3**	345.4
Other intangibles	**890.6**	834.6
Separate account assets	**71,364.4**	69,555.3
Other assets	**942.2**	1,323.3
Total assets	**$ 148,298.0**	$ 145,631.1
Liabilities		
Contractholder funds	**$ 37,676.4**	$ 37,301.1
Future policy benefits and claims	**20,207.9**	20,046.3
Other policyholder funds	**543.7**	592.2
Short-term debt	**105.2**	107.9
Long-term debt	**1,564.8**	1,583.7
Income taxes currently payable	**3.1**	6.2
Deferred income taxes	**533.4**	409.9
Separate account liabilities	**71,364.4**	69,555.3
Other liabilities (2011 and 2010 include $565.2 million and $433.6 million related to consolidated variable interest entities, of which $88.4 million and $114.5 million are measured at fair value under the fair value option)	**6,286.1**	6,143.5
Total liabilities	**138,285.0**	135,746.1
Stockholders' equity		
Series A preferred stock, par value $.01 per share with liquidation preference of $100 per share 3.0 million shares authorized, issued and outstanding in 2011 and 2010		
Series B preferred stock, par value $.01 per share with liquidation preference of $25 per share 10.0 million shares authorized, issued and outstanding in 2011 and 2010	**0.1**	0.1
Common stock, par value $.01 per share 2,500.0 million shares authorized, 450.3 million and 448.5 million shares issued, and 301.1 million and 320.4 million shares outstanding in 2011 and 2010	**4.5**	4.5
Additional paid-in capital	**9,634.7**	9,563.8
Retained earnings	**5,077.5**	4,612.3
Accumulated other comprehensive income	**201.9**	272.4
Treasury stock, at cost (149.2 million and 128.1 million shares in 2011 and 2010)	**(5,281.7)**	(4,725.3)
Total stockholders' equity attributable to Principal Financial Group, Inc.	**9,637.0**	9,727.8

Noncontrolling interest	**376.0**	157.2
Total stockholders' equity	**10,013.0**	9,885.0
Total liabilities and stockholders' equity	**$ 148,298.0**	$ 145,631.1

See accompanying notes.

Table of Contents

Principal Financial Group, Inc.

Consolidated Statements of Operations

	For the year ended December 31,		
	2011	**2010**	**2009**
	(in millions, except per share data)		
Revenues			
Premiums and other considerations	**$ 2,891.0**	$ 3,555.5	$ 3,750.6
Fees and other revenues	**2,565.1**	2,298.1	2,096.0
Net investment income	**3,375.8**	3,496.5	3,400.8
Net realized capital gains, excluding impairment losses on available-for-sale securities	**75.0**	48.7	54.9
Total other-than-temporary impairment losses on available-for-sale securities	**(147.6)**	(296.3)	(714.1)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income	**(49.7)**	56.1	260.9
Net impairment losses on available-for-sale securities	**(197.3)**	(240.2)	(453.2)
Net realized capital losses	**(122.3)**	(191.5)	(398.3)
Total revenues	**8,709.6**	9,158.6	8,849.1
Expenses			
Benefits, claims and settlement expenses	**4,454.1**	5,338.4	5,334.5
Dividends to policyholders	**210.2**	219.9	242.2
Operating expenses	**3,057.7**	2,759.0	2,526.6
Total expenses	**7,722.0**	8,317.3	8,103.3
Income before income taxes	**987.6**	841.3	745.8
Income taxes	**236.4**	124.1	100.1
Net income	**751.2**	717.2	645.7
Net income attributable to noncontrolling interest	**36.2**	17.9	23.0
Net income attributable to Principal Financial Group, Inc.	**715.0**	699.3	622.7
Preferred stock dividends	**33.0**	33.0	33.0
Net income available to common stockholders	**$ 682.0**	$ 666.3	$ 589.7
Earnings per common share			
Basic earnings per common share	**$ 2.17**	$ 2.08	$ 1.98
Diluted earnings per common share	**$ 2.15**	$ 2.06	$ 1.97

See accompanying notes.

Table of Contents

Principal Financial Group, Inc.

Consolidated Statements of Stockholders' Equity

	Series A preferred stock	Series B preferred stock	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Noncontrolling interest	Total stockholders' equity
					(in millions)				
Balances at January 1, 2009	$	$ 0.1	$ 3.9	$ 8,376.5	$ 3,722.5	$ (4,911.6)	$ (4,718.6)	$ 96.5	$ 2,569.3
Common stock issued			0.6	1,122.4					1,123.0
Stock-based compensation and additional related tax benefits				39.9	(1.9)				38.0
Treasury stock acquired, common							(4.1)		(4.1)
Dividends to common stockholders					(159.5)				(159.5)
Dividends to preferred stockholders					(33.0)				(33.0)
Distributions to noncontrolling interest								(7.1)	(7.1)
Contributions from noncontrolling interest								10.1	10.1
Purchase of subsidiary shares from noncontrolling interest				(45.9)				0.2	(45.7)
Effects of reclassifying noncredit component of previously recognized impairment losses on fixed maturities, available-for-sale, net					9.9	(9.9)			
Comprehensive income:									
Net income					622.7			23.0	645.7
Net unrealized gains, net						3,693.1			3,693.1
Noncredit component of impairment losses on fixed maturities, available-for-sale, net						(152.9)			(152.9)
Foreign currency translation adjustment, net of related income taxes						168.2		0.2	168.4
Unrecognized postretirement benefit obligation, net of related income taxes						171.1			171.1
Comprehensive income									4,525.4
Balances at December 31, 2009		0.1	4.5	9,492.9	4,160.7	(1,042.0)	(4,722.7)	122.9	8,016.4
Common stock issued				20.6					20.6
Stock-based compensation and additional related tax benefits				50.3	(2.4)				47.9
Treasury stock acquired, common							(2.6)		(2.6)
Dividends to common stockholders					(176.2)				(176.2)
Dividends to preferred stockholders					(33.0)				(33.0)
Distributions to noncontrolling interest								(7.8)	(7.8)
Contributions from noncontrolling interest								24.0	24.0
Effects of implementation of accounting change related to variable interest entities, net					(10.7)	10.7			
Effects of electing fair value option for fixed maturities upon implementation of accounting change related to embedded credit derivatives, net					(25.4)	25.4			
Comprehensive income:									
Net income					699.3			17.9	717.2
Net unrealized gains, net						1,070.6			1,070.6
Noncredit component of impairment losses on fixed maturities, available-for-sale, net						(33.5)			(33.5)
Foreign currency translation adjustment, net of related income taxes						33.2		0.2	33.4
Unrecognized postretirement benefit obligation, net of related income taxes						208.0			208.0
Comprehensive income									1,995.7

Balances at December 31, 2010	$	$ 0.1	$ 4.5	$ 9,563.8	$ 4,612.3	$ 272.4	$ (4,725.3)	$ 157.2	$ 9,885.0

Table of Contents

Principal Financial Group, Inc.

Consolidated Statements of Stockholders' Equity (continued)

	Series A preferred stock	Series B preferred stock	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Noncontrolling interest	Total stockholders' equity
					(in millions)				
Balances at January 1, 2011	$	$ 0.1	$ 4.5	$ 9,563.8	$ 4,612.3	$ 272.4	$ (4,725.3)	$ 157.2	$ 9,885.0
Common stock issued				25.9					25.9
Stock-based compensation and additional related tax benefits				47.0	(3.1)				43.9
Treasury stock acquired, common							(556.4)		(556.4)
Dividends to common stockholders					(213.7)				(213.7)
Dividends to preferred stockholders					(33.0)				(33.0)
Distributions to noncontrolling interest								(9.8)	(9.8)
Contributions from noncontrolling interest								196.7	196.7
Purchase of subsidiary shares from noncontrolling interest				(2.0)				(3.7)	(5.7)
Comprehensive income:									
Net income					715.0			36.2	751.2
Net unrealized gains, net						213.7			213.7
Noncredit component of impairment losses on fixed maturities, available-for-sale, net						31.4			31.4
Foreign currency translation adjustment, net of related income taxes						(142.7)		(0.6)	(143.3)
Unrecognized postretirement benefit obligation, net of related income taxes						(172.9)			(172.9)
Comprehensive income									680.1
Balances at December 31, 2011	$	$ 0.1	$ 4.5	$ 9,634.7	$ 5,077.5	$ 201.9	$ (5,281.7)	$ 376.0	$ 10,013.0

See accompanying notes.

Principal Financial Group, Inc.

Consolidated Statements of Cash Flows

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in millions)	
Operating activities			
Net income	**$ 751.2**	$ 717.2	$ 645.7
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of deferred policy acquisition costs	**538.0**	205.9	92.2
Additions to deferred policy acquisition costs	**(520.5)**	(496.3)	(482.4)
Accrued investment income	**50.9**	25.8	58.8
Net cash flows for trading securities	**110.8**	188.3	(127.4)
Premiums due and other receivables	**(220.4)**	(9.6)	(126.9)
Contractholder and policyholder liabilities and dividends	**1,090.7**	1,384.2	1,530.9
Current and deferred income taxes	**51.3**	60.9	65.7
Net realized capital losses	**122.3**	191.5	398.3
Depreciation and amortization expense	**115.8**	164.7	138.5
Mortgage loans held for sale, acquired or originated	**(132.3)**	(60.6)	(61.2)
Mortgage loans held for sale, sold or repaid, net of gain	**82.0**	61.2	75.4
Real estate acquired through operating activities	**(37.4)**		(19.8)
Real estate sold through operating activities	**141.8**	121.6	5.2
Stock-based compensation	**43.4**	47.6	37.2
Other	**525.7**	189.3	12.8
Net adjustments	**1,962.1**	2,074.5	1,597.3
Net cash provided by operating activities	**2,713.3**	2,791.7	2,243.0
Investing activities			
Available-for-sale securities:			
Purchases	**(6,742.4)**	(7,187.9)	(7,933.3)
Sales	**980.7**	1,684.6	3,439.8
Maturities	**5,760.8**	5,161.3	4,568.1
Mortgage loans acquired or originated	**(1,484.9)**	(1,272.0)	(586.5)
Mortgage loans sold or repaid	**1,793.1**	1,798.0	1,704.4
Real estate acquired	**(129.9)**	(53.8)	(62.2)
Net purchases of property and equipment	**(56.9)**	(21.5)	(26.2)
Purchases of interest in subsidiaries, net of cash acquired	**(270.5)**		(45.7)
Net change in other investments	**(52.1)**	(81.2)	(31.6)
Net cash provided by (used in) investing activities	**(202.1)**	27.5	1,026.8
Financing activities			
Issuance of common stock	**25.9**	20.6	1,123.0
Acquisition of treasury stock	**(556.4)**	(2.6)	(4.1)
Proceeds from financing element derivatives	**75.9**	79.3	122.0
Payments for financing element derivatives	**(46.5)**	(46.5)	(67.4)
Excess tax benefits from share-based payment arrangements	**2.0**	1.0	0.2
Dividends to common stockholders	**(213.7)**	(176.2)	(159.5)
Dividends to preferred stockholders	**(33.0)**	(33.0)	(33.0)
Issuance of long-term debt		2.3	745.1
Principal repayments of long-term debt	**(12.2)**	(11.1)	(468.2)
Net proceeds from (repayments of) short-term borrowings	**3.2**	1.7	(405.1)
Investment contract deposits	**6,302.1**	4,283.8	4,224.1
Investment contract withdrawals	**(7,079.0)**	(7,343.4)	(8,752.7)
Net increase (decrease) in banking operation deposits	**(18.5)**	46.2	43.9
Other	**(4.5)**	(4.3)	(5.7)
Net cash used in financing activities	**(1,554.7)**	(3,182.2)	(3,637.4)
Net increase (decrease) in cash and cash equivalents	**956.5**	(363.0)	(367.6)

Cash and cash equivalents at beginning of year		**1,877.4**		2,240.4		2,608.0
Cash and cash equivalents at end of year	**$**	**2,833.9**	$	1,877.4	$	2,240.4
Supplemental Information:						
Cash paid for interest	**$**	**154.1**	$	123.4	$	129.9
Cash paid for income taxes	**$**	**152.8**	$	55.2	$	75.4

See accompanying notes.

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements

December 31, 2011

1. Nature of Operations and Significant Accounting Policies

Description of Business

Principal Financial Group, Inc. ("PFG"), along with its consolidated subsidiaries, is a diversified financial services organization engaged in promoting retirement savings and investment and insurance products and services in the U.S. and selected international markets.

Basis of Presentation

The accompanying consolidated financial statements include the accounts of PFG and all other entities in which we directly or indirectly have a controlling financial interest as well as those variable interest entities ("VIEs") in which we are the primary beneficiary. Entities in which we have significant management influence over the operating and financing decisions but are not required to consolidate are reported using the equity method. The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ("U.S. GAAP"). All significant intercompany accounts and transactions have been eliminated.

Reclassifications have been made to prior period financial statements to conform to the December 31, 2011, presentation.

Closed Block

Principal Life Insurance Company ("Principal Life") operates a closed block ("Closed Block") for the benefit of individual participating dividend-paying policies in force at the time of the 1998 mutual insurance holding company ("MIHC") formation. See Note 6, Closed Block, for further details.

Recent Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board ("FASB") issued authoritative guidance related to balance sheet offsetting. The new guidance requires disclosures about assets and liabilities that are offset or have the potential to be offset. These disclosures are intended to address differences in the asset and liability offsetting requirements under U.S. GAAP and International Financial Reporting Standards. This new guidance will be effective for us for interim and annual reporting periods beginning January 1, 2013, with retrospective application required and is not expected to have a material impact on our consolidated financial statements.

Also in December 2011, the FASB issued authoritative guidance that requires a reporting entity to follow the real estate sales guidance when the reporting entity ceases to have a controlling financial interest in a subsidiary that is in-substance real estate as a result of a default on the subsidiary's nonrecourse debt. This guidance will be effective for us on January 1, 2013, and is not expected to have a material impact on our consolidated financial statements.

In September 2011, the FASB issued authoritative guidance that amends how goodwill is tested for impairment. The amendments provide an option to perform a qualitative assessment to determine whether it is necessary to perform the annual two-step quantitative goodwill impairment test. This guidance will be effective for our 2012 goodwill impairment test and is not expected to have a material impact on our consolidated financial statements.

In June 2011, the FASB issued authoritative guidance that changes the presentation of comprehensive income in the financial statements. The new guidance eliminates the presentation options contained in current guidance and instead requires entities to report components of comprehensive income in either a continuous statement of comprehensive income or two separate but consecutive statements that show the components of net income and other comprehensive income, including adjustments for items that are reclassified from other comprehensive income to net income. The guidance does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. This guidance will be effective for us on January 1, 2012, and is not expected to have a material impact on our consolidated financial statements. In December 2011, the FASB issued a final standard to defer the new requirement to present reclassification adjustments out of other comprehensive income to net income on the face of the financial statements. All other requirements contained in the original statement on comprehensive income are still effective.

In May 2011, the FASB issued authoritative guidance that clarifies and changes fair value measurement and disclosure requirements. This guidance expands existing disclosure requirements for fair value measurements and makes other amendments but does not require additional fair value measurements. This guidance will be effective for us on January 1, 2012, and is not expected to have a material impact on our consolidated financial statements.

In April 2011, the FASB issued authoritative guidance that modifies the criteria for determining when repurchase agreements would be accounted for as secured borrowings as opposed to sales. The guidance will be effective for us on

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

January 1, 2012, for new transfers and modifications to existing transactions. This guidance is not expected to have a material impact on our consolidated financial statements.

Also in April 2011, the FASB issued authoritative guidance which clarifies when creditors should classify a loan modification as a troubled debt restructuring ("TDR"). A TDR occurs when a creditor grants a concession to a debtor experiencing financial difficulties. Loans denoted as a TDR are considered impaired and are specifically reserved for when calculating the allowance for credit losses. This guidance also ends the indefinite deferral issued in January 2011 surrounding new disclosures on loans classified as a TDR required as part of the credit quality disclosures guidance issued in July 2010. This guidance was effective for us on July 1, 2011, and was applied retrospectively to restructurings occurring on or after January 1, 2011. This guidance did not have a material impact on our consolidated financial statements. See Note 4, Investments, for further details.

In October 2010, the FASB issued authoritative guidance that modifies the definition of the types of costs incurred by insurance entities that can be capitalized in the successful acquisition of new or renewal insurance contracts. Capitalized costs should include incremental direct costs of contract acquisition, as well as certain costs related directly to acquisition activities such as underwriting, policy issuance and processing, medical and inspection and sales force contract selling. This guidance will be effective for us on January 1, 2012. We will adopt this guidance retrospectively. Our retrospective adoption will result in a reduction to the opening balance of retained earnings of approximately $640.0 million at January 1, 2012.

In July 2010, the FASB issued authoritative guidance that requires new and expanded disclosures related to the credit quality of financing receivables and the allowance for credit losses. Reporting entities are required to provide qualitative and quantitative disclosures on the allowance for credit losses, credit quality, impaired loans, modifications and nonaccrual and past due financing receivables. The disclosures are required to be presented on a disaggregated basis by portfolio segment and class of financing receivable. Disclosures required by the guidance that relate to the end of a reporting period were effective for us in our December 31, 2010, consolidated financial statements. Disclosures required by the guidance that relate to an activity that occurs during a reporting period were effective for us on January 1, 2011, and did not have a material impact on our consolidated financial statements. See Note 4, Investments, for further details.

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

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

In January 2010, the FASB issued authoritative guidance that requires new disclosures related to fair value measurements and clarifies existing disclosure requirements about the level of disaggregation, inputs and valuation techniques. Specifically, reporting entities now must disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers. In addition, in the reconciliation for Level 3 fair value measurements, a reporting entity should present separately information about purchases, sales, issuances and settlements. The guidance clarifies that a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities for disclosure of fair value measurement, considering the level of disaggregated information required by other applicable U.S. GAAP guidance and should also provide disclosures about the valuation techniques and inputs used to measure fair value for each class of assets and liabilities. This guidance was effective for us on January 1, 2010, except for the disclosures about purchases, sales, issuances and settlements in the reconciliation for Level 3 fair value measurements, which were effective for us on January 1, 2011. This guidance did not have a material impact on our consolidated financial statements. See Note 14, Fair Value Measurements, for further details.

In September 2009, FASB issued authoritative guidance for measuring the fair value of certain alternative investments and to offer investors a practical means for measuring the fair value of investments in certain entities that

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

calculate net asset value per share. This guidance was effective for us on October 1, 2009, and did not have a material impact on our consolidated financial statements.

In August 2009, the FASB issued authoritative guidance to provide additional guidance on measuring the fair value of liabilities. This guidance clarifies that the quoted price for the identical liability, when traded as an asset in an active market, is also a Level 1 measurement for that liability when no adjustment to the quoted price is required. In the absence of a quoted price in an active market, an entity must use one or more of the following valuation techniques to estimate fair value: (1) a valuation technique that uses a quoted price (a) of an identical liability when traded as an asset or (b) of a similar liability when traded as an asset; or (2) another valuation technique such as (a) a present value technique or (b) a technique based on the amount an entity would pay to transfer the identical liability or would receive to enter into an identical liability. This guidance was effective for us on October 1, 2009, and did not have a material impact on our consolidated financial statements.

In June 2009, the FASB issued authoritative guidance for the establishment of the *FASB Accounting Standards Codification™* ("Codification") as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. GAAP. Rules and interpretive releases of the Securities and Exchange Commission ("SEC") under federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority. This guidance was effective for us on July 1, 2009, and did not have a material impact on our consolidated financial statements.

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

Also in June 2009, the FASB issued authoritative guidance related to the accounting for VIEs, which amends prior guidance and requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a VIE. This analysis identifies the primary beneficiary of a VIE as the enterprise with (1) the power to direct the activities of a VIE that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE. In addition, this guidance requires ongoing reassessments of whether an enterprise is the primary beneficiary of a VIE. Furthermore, we are required to enhance disclosures that will provide users of financial statements with more transparent information about an enterprise's involvement in a VIE. We adopted this guidance prospectively effective January 1, 2010. Due to the implementation of this guidance, certain previously unconsolidated VIEs were consolidated and certain previously consolidated VIEs were deconsolidated. The cumulative change in accounting principle from adopting this guidance resulted in a net $10.7 million decrease to retained earnings and a net $10.7 million increase to AOCI. In February 2010, the FASB issued an amendment to this guidance. The amendment indefinitely defers the consolidation requirements for reporting enterprises' interests in entities that have the characteristics of investment companies and regulated money market funds. This amendment was effective January 1, 2010, and did not have a material impact to our consolidated financial statements. The required disclosures are included in our consolidated financial statements. See Note 3, Variable Interest Entities, for further details.

In April 2009, the FASB issued authoritative guidance which relates to the recognition and presentation of an other-than-temporary impairment ("OTTI") of securities and requires additional disclosures. The recognition provisions apply only to debt securities classified as available-for-sale and held-to-maturity, while the presentation and disclosure requirements apply to both debt and equity securities. An impaired debt security will be considered other-than-temporarily impaired if a holder has the intent to sell, or it more likely than not will be required to sell prior to recovery of the amortized cost. If a holder of a debt security does not expect recovery of the entire cost basis, even if there is no intention to sell the security, it will be considered an OTTI as well. This guidance also changes how an entity recognizes an OTTI for a debt security by separating the loss between the amount representing the credit loss and the amount relating to other factors, if a holder does not have the intent to sell or it more likely than not will not be required to sell prior to recovery of the amortized cost less any current period credit loss. Credit losses will be recognized in net income and losses relating to other factors will be recognized in other comprehensive income ("OCI"). If the holder has the intent to sell or it more likely than not will be required to sell before its recovery of amortized cost less any current period credit loss, the entire OTTI will continue to be recognized in net income. Furthermore, this guidance requires a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption with a corresponding

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

adjustment to accumulated OCI. We adopted this guidance effective January 1, 2009. The cumulative change in accounting principle from adopting this guidance resulted in a net $9.9 million increase to retained earnings and a corresponding decrease to accumulated OCI. The required disclosures have been included in our consolidated financial statements.

Also in April 2009, the FASB issued authoritative guidance which provides additional information on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity for the asset or liability and clarifies that the use of multiple valuation techniques may be appropriate. It also provides additional guidance on circumstances that may indicate a transaction is not orderly. Further, it requires additional disclosures about fair value measurements in annual and interim reporting periods. We adopted this guidance effective January 1, 2009, and it did not have a material impact on our consolidated financial statements. See Note 14, Fair Value Measurements, for further details.

In March 2008, the FASB issued authoritative guidance requiring (1) qualitative disclosures about objectives and strategies for using derivatives, (2) quantitative disclosures about fair value amounts of gains and losses on derivative instruments and related hedged items and (3) disclosures about credit-risk-related contingent features in derivative instruments. The disclosures are intended to provide users of financial statements with an enhanced understanding of how and why derivative instruments are used, how they are accounted for and the financial statement impacts. We adopted these changes on January 1, 2009. See Note 5, Derivative Financial Instruments, for further details.

In December 2007, the FASB issued authoritative guidance requiring that the acquiring entity in a business combination establish the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed, including any noncontrolling interests, and requires the acquirer to disclose additional information needed to more comprehensively evaluate and understand the nature and financial effect of the business combination. In addition, direct acquisition costs are to be expensed. We adopted this guidance on January 1, 2009.

Also in December 2007, the FASB issued authoritative guidance mandating the following changes to noncontrolling interests:

(1) Noncontrolling interests are to be treated as a separate component of equity, rather than as a liability or other item outside of equity.

(2) Net income includes the total income of all consolidated subsidiaries, with separate disclosures on the face of the statement of operations of the income attributable to controlling and noncontrolling interests. Previously, net income attributable to the noncontrolling interest was reported as an operating expense in arriving at consolidated net income.

(3) This guidance revises the accounting requirements for changes in a parent's ownership interest when the parent retains control and for changes in a parent's ownership interest that results in deconsolidation.

We adopted this guidance on January 1, 2009.

Use of Estimates in the Preparation of Financial Statements

The preparation of our consolidated financial statements and accompanying notes requires management to make estimates and assumptions that affect the amounts reported and disclosed. These estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed in the consolidated financial statements and accompanying notes. The most critical estimates include those used in determining:

- the fair value of investments in the absence of quoted market values;

investment impairments and valuation allowances;

the fair value of and accounting for derivatives;

the deferred policy acquisition costs ("DPAC") and other actuarial balances where the amortization is based on estimated gross profits;

the measurement of goodwill, indefinite lived intangible assets, finite lived intangible assets and related impairments or amortization, if any;

the liability for future policy benefits and claims;

the value of our pension and other postretirement benefit obligations and

accounting for income taxes and the valuation of deferred tax assets.

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

A description of such critical estimates is incorporated within the discussion of the related accounting policies that follow. In applying these policies, management makes subjective and complex judgments that frequently require estimates about matters that are inherently uncertain. Many of these policies, estimates and related judgments are common in the insurance and financial services industries; others are specific to our businesses and operations. Actual results could differ from these estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, money market instruments and other debt issues with a maturity date of three months or less when purchased.

Investments

Fixed maturities include bonds, ABS, redeemable preferred stock and certain nonredeemable preferred stock. Equity securities include mutual funds, common stock and nonredeemable preferred stock. We classify fixed maturities and equity securities as either available-for-sale or trading at the time of the purchase and, accordingly, carry them at fair value. See Note 14, Fair Value Measurements, for methodologies related to the determination of fair value. Unrealized gains and losses related to available-for-sale securities, excluding those in fair value hedging relationships, are reflected in stockholders' equity, net of adjustments related to DPAC, sales inducements, unearned revenue reserves, policyholder liabilities, derivatives in cash flow hedge relationships and applicable income taxes. Unrealized gains and losses related to hedged portions of available-for-sale securities in fair value hedging relationships and mark-to-market adjustments on certain trading securities are reflected in net realized capital gains (losses). We also have a minimal amount of assets within trading securities portfolios that support investment strategies that involve the active and frequent purchase and sale of fixed maturities. Mark-to-market adjustments related to these trading securities are reflected in net investment income.

The cost of fixed maturities is adjusted for amortization of premiums and accrual of discounts, both computed using the interest method. The cost of fixed maturities and equity securities classified as available-for-sale is adjusted for declines in value that are other than temporary. Impairments in value deemed to be other than temporary are primarily reported in net income as a component of net realized capital gains (losses), with noncredit impairment losses for certain fixed maturities, available-for-sale reported in OCI. Interest income, as well as prepayment fees and the amortization of the related premium or discount, is reported in net income. For loan-backed and structured securities, we recognize income using a constant effective yield based on currently anticipated cash flows.

Real estate investments are reported at cost less accumulated depreciation. The initial cost basis of properties acquired through loan foreclosures are the lower of the fair market values of the properties at the time of foreclosure or the outstanding loan balance. Buildings and land improvements are generally depreciated on the straight-line method over the estimated useful life of improvements and tenant improvement costs are depreciated on the straight-line method over the term of the related lease. We recognize impairment losses for properties when indicators of impairment are present and a property's expected undiscounted cash flows are not sufficient to recover the property's carrying value. In such cases, the cost basis of the properties are reduced to fair value. Real estate expected to be disposed is carried at the lower of cost or fair value, less cost to sell, with valuation allowances established accordingly and depreciation no longer recognized. The carrying amount of real estate held for sale was $44.8 million and $51.9 million as of December 31, 2011 and 2010, respectively. Any impairment losses and any changes in valuation allowances are reported in net income.

Commercial and residential mortgage loans are generally reported at cost adjusted for amortization of premiums and accrual of discounts, computed using the interest method, net of valuation allowances. Interest income is accrued on the principal amount of the loan based on the loan's contractual interest rate. Interest income, as well as prepayment of fees and the amortization of the related premium or discount, is reported in net investment income. Any changes in the valuation allowances are reported in net income as net realized capital gains (losses). We measure impairment based upon the difference between carrying value and estimated value less cost to sell. Estimated value is based on either the present value of expected cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral. If foreclosure is probable, the measurement of any valuation allowance is based upon the fair value of the collateral.

Net realized capital gains and losses on sales of investments are determined on the basis of specific identification. In general, in addition to realized capital gains and losses on investment sales and periodic settlements on derivatives not designated as hedges, we report gains and losses related to the following in net realized capital gains (losses): other-than-temporary impairments of securities and subsequent realized recoveries, mark-to-market adjustments on certain trading securities, mark-to-market adjustments on certain seed money investments, fair value hedge and cash flow hedge ineffectiveness, mark-to-market adjustments on derivatives not designated as hedges, changes in the mortgage loan valuation allowance provision and impairments of real estate held for investment. Investment gains and losses on sales of

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

certain real estate held for sale that do not meet the criteria for classification as a discontinued operation and mark-to-market adjustments on trading securities that support investment strategies that involve the active and frequent purchase and sale of fixed maturities are reported as net investment income and are excluded from net realized capital gains (losses).

Policy loans and other investments, excluding investments in unconsolidated entities and commercial mortgage loans of consolidated VIEs for which the fair value option was elected, are primarily reported at cost.

Derivatives

Overview. Derivatives are financial instruments whose values are derived from interest rates, foreign exchange rates, financial indices or the values of securities. Derivatives generally used by us include interest rate swaps, interest rate collars, swaptions, futures, currency swaps, currency forwards, credit default swaps, options and total return swaps. Derivatives may be exchange traded or contracted in the over-the-counter market. Derivative positions are either assets or liabilities in the consolidated statements of financial position and are measured at fair value, generally by obtaining quoted market prices or through the use of pricing models. See Note 14, Fair Value Measurements, for policies related to the determination of fair value. Fair values can be affected by changes in interest rates, foreign exchange rates, financial indices, values of securities, credit spreads, and market volatility and liquidity.

Accounting and Financial Statement Presentation. We designate derivatives as either:

(a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, including those denominated in a foreign currency ("fair value hedge");

(b) a hedge of a forecasted transaction or the exposure to variability of cash flows to be received or paid related to a recognized asset or liability, including those denominated in a foreign currency ("cash flow hedge");

(c) a hedge of a net investment in a foreign operation or

(d) a derivative not designated as a hedging instrument.

Our accounting for the ongoing changes in fair value of a derivative depends on the intended use of the derivative and the designation, as described above, and is determined when the derivative contract is entered into or at the time of redesignation. Hedge accounting is used for derivatives that are specifically designated in advance as hedges and that reduce our exposure to an indicated risk by having a high correlation between changes in the value of the derivatives and the items being hedged at both the inception of the hedge and throughout the hedge period.

Fair Value Hedges. When a derivative is designated as a fair value hedge and is determined to be highly effective, changes in its fair value, along with changes in the fair value of the hedged asset, liability or firm commitment attributable to the hedged risk, are reported in net realized capital gains (losses). Any difference between the net change in fair value of the derivative and the hedged item represents hedge ineffectiveness.

Cash Flow Hedges. When a derivative is designated as a cash flow hedge and is determined to be highly effective, changes in its fair value are recorded as a component of OCI. Any hedge ineffectiveness is recorded immediately in net income. At the time the variability of cash flows being hedged impacts net income, the related portion of deferred gains or losses on the derivative instrument is reclassified and reported in net income.

Net Investment in a Foreign Operation Hedge. When a derivative is used as a hedge of a net investment in a foreign operation, its change in fair value, to the extent effective as a hedge, is recorded as a component of OCI. Any hedge ineffectiveness is recorded immediately in net income. If the foreign operation is sold or upon complete or substantially complete liquidation, the deferred gains or losses on the derivative instrument are reclassified into net income.

Non-Hedge Derivatives. If a derivative does not qualify or is not designated for hedge accounting, all changes in fair value are reported in net income without considering the changes in the fair value of the economically associated assets or liabilities.

Hedge Documentation and Effectiveness Testing. At inception, we formally document all relationships between hedging instruments and hedged items, as well as our risk management objective and strategy for undertaking various hedge transactions. This process includes associating all derivatives designated as fair value or cash flow hedges with specific assets or liabilities on the statement of financial position or with specific firm commitments or forecasted transactions. Effectiveness of the hedge is formally assessed at inception and throughout the life of the hedging relationship. Even if a derivative is highly effective and qualifies for hedge accounting treatment, the hedge might have some ineffectiveness.

We use qualitative and quantitative methods to assess hedge effectiveness. Qualitative methods may include monitoring changes to terms and conditions and counterparty credit ratings. Quantitative methods may include statistical tests including regression analysis and minimum variance and dollar offset techniques.

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

Termination of Hedge Accounting. We prospectively discontinue hedge accounting when (1) the criteria to qualify for hedge accounting is no longer met, e.g., a derivative is determined to no longer be highly effective in offsetting the change in fair value or cash flows of a hedged item; (2) the derivative expires, is sold, terminated or exercised or (3) we remove the designation of the derivative being the hedging instrument for a fair value or cash flow hedge.

If it is determined that a derivative no longer qualifies as an effective hedge, the derivative will continue to be carried on the consolidated statements of financial position at its fair value, with changes in fair value recognized prospectively in net realized capital gains (losses). The asset or liability under a fair value hedge will no longer be adjusted for changes in fair value pursuant to hedging rules and the existing basis adjustment is amortized to the consolidated statements of operations line associated with the asset or liability. The component of OCI related to discontinued cash flow hedges that are no longer highly effective is amortized to the consolidated statements of operations consistent with the net income impacts of the original hedged cash flows. If a cash flow hedge is discontinued because it is probable the hedged forecasted transaction will not occur, the deferred gain or loss is immediately reclassified from OCI into net income.

Embedded Derivatives. We purchase and issue certain financial instruments and products that contain a derivative that is embedded in the financial instrument or product. We assess whether this embedded derivative is clearly and closely related to the asset or liability that serves as its host contract. If we deem that the embedded derivative's terms are not clearly and closely related to the host contract, and a separate instrument with the same terms would qualify as a derivative instrument, the derivative is bifurcated from that contract and held at fair value on the consolidated statements of financial position, with changes in fair value reported in net income.

Contractholder and Policyholder Liabilities

Contractholder and policyholder liabilities (contractholder funds, future policy benefits and claims and other policyholder funds) include reserves for investment contracts and reserves for universal life, term life insurance, participating traditional individual life insurance, group life insurance, accident and health insurance and disability income policies, as well as a provision for dividends on participating policies.

Investment contracts are contractholders' funds on deposit with us and generally include reserves for pension and annuity contracts. Reserves on investment contracts are equal to the cumulative deposits less any applicable charges and withdrawals plus credited interest. Reserves for universal life insurance contracts are equal to cumulative deposits less charges plus credited interest, which represents the account balances that accrue to the benefit of the policyholders.

We hold additional reserves on certain long duration contracts where benefit features result in gains in early years followed by losses in later years, universal life/variable universal life contracts that contain no lapse guarantee features, or annuities with guaranteed minimum death benefits.

Reserves for nonparticipating term life insurance and disability income contracts are computed on a basis of assumed investment yield, mortality, morbidity and expenses, including a provision for adverse deviation, which generally varies by plan, year of issue and policy duration. Investment yield is based on our experience. Mortality, morbidity and withdrawal rate assumptions are based on our experience and are periodically reviewed against both industry standards and experience.

Reserves for participating life insurance contracts are based on the net level premium reserve for death and endowment policy benefits. This net level premium reserve is calculated based on dividend fund interest rates and mortality rates guaranteed in calculating the cash surrender values described in the contract.

Participating business represented approximately 15%, 16% and 17% of our life insurance in force and 50%, 53% and 55% of the number of life insurance policies in force at December 31, 2011, 2010 and 2009, respectively. Participating business represented approximately 47%, 49% and 52% of life insurance premiums for the years ended December 31, 2011, 2010 and 2009, respectively. The amount of dividends to policyholders is declared annually by Principal Life's Board of Directors. The amount of dividends to be paid to policyholders is determined after consideration of several factors including interest, mortality, morbidity and other expense experience for the year and judgment as to the appropriate level of statutory surplus to be retained by Principal Life. At the end of the reporting period, Principal Life establishes a dividend liability for the pro rata portion of the dividends expected to be paid on or before the next policy anniversary date.

Some of our policies and contracts require payment of fees or other policyholder assessments in advance for services that will be rendered over the estimated lives of the policies and contracts. These payments are established as unearned revenue liabilities upon receipt and included in other policyholder funds in the consolidated statements of financial position. These unearned revenue reserves are amortized to operations over the estimated lives of these policies and contracts in relation to the emergence of estimated gross profit margins.

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

The liability for unpaid accident and health claims is an estimate of the ultimate net cost of reported and unreported losses not yet settled. This liability is estimated using actuarial analyses and case basis evaluations. Although considerable variability is inherent in such estimates, we believe that the liability for unpaid claims is adequate. These estimates are continually reviewed and, as adjustments to this liability become necessary, such adjustments are reflected in net income.

Recognition of Premiums and Other Considerations, Fees and Other Revenues and Benefits

Traditional individual life insurance products include those products with fixed and guaranteed premiums and benefits and consist principally of whole life and term life insurance policies. Premiums from these products are recognized as premium revenue when due. Related policy benefits and expenses for individual life products are associated with earned premiums and result in the recognition of profits over the expected term of the policies and contracts.

Immediate annuities with life contingencies include products with fixed and guaranteed annuity considerations and benefits and consist principally of group and individual single premium annuities with life contingencies. Annuity considerations from these products are recognized as revenue. However, the collection of these annuity considerations does not represent the completion of the earnings process, as we establish annuity reserves, using estimates for mortality and investment assumptions, which include provision for adverse deviation as required by U.S. GAAP. We anticipate profits to emerge over the life of the annuity products as we earn investment income, pay benefits and release reserves.

Group life and health insurance premiums are generally recorded as premium revenue over the term of the coverage. Certain group contracts contain experience premium refund provisions based on a pre-defined formula that reflects their claim experience. Experience premium refunds reduce revenue over the term of the coverage and are adjusted to reflect current experience. Related policy benefits and expenses for group life and health insurance products are associated with earned premiums and result in the recognition of profits over the term of the policies and contracts. Fees for contracts providing claim processing or other administrative services are recorded as revenue over the period the service is provided.

Universal life-type policies are insurance contracts with terms that are not fixed. Amounts received as payments for such contracts are not reported as premium revenues. Revenues for universal life-type insurance contracts consist of policy charges for the cost of insurance, policy initiation and administration, surrender charges and other fees that have been assessed against policy account values and investment income. Policy benefits and claims that are charged to expense include interest credited to contracts and benefit claims incurred in the period in excess of related policy account balances.

Investment contracts do not subject us to significant risks arising from policyholder mortality or morbidity and consist primarily of guaranteed investment contracts ("GICs"), funding agreements and certain deferred annuities. Amounts received as payments for investment contracts are established as investment contract liability balances and are not reported as premium revenues. Revenues for investment contracts consist of investment income and policy administration charges. Investment contract benefits that are charged to expense include benefit claims incurred in the period in excess of related investment contract liability balances and interest credited to investment contract liability balances.

Fees and other revenues are earned for asset management services provided to retail and institutional clients based largely upon contractual rates applied to the market value of the client's portfolio. Additionally, fees and other revenues are earned for administrative services performed including recordkeeping and reporting services for retirement savings plans. Fees and other revenues received for performance of asset management and administrative services are recognized as revenue when earned, typically when the service is performed.

Deferred Policy Acquisition Costs

Commissions and other costs (underwriting, issuance and field 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 operations as incurred.

DPAC for universal life-type insurance contracts, participating life insurance policies and certain investment contracts are being amortized over the lives of the policies and contracts in relation to the emergence of estimated gross profit margins. This amortization is adjusted in the current period when estimated gross profits are revised. For individual variable life insurance, individual variable annuities and group annuities which have separate account equity investment options, we utilize a mean reversion method (reversion to the mean assumption), a common industry practice, to determine the future domestic equity market growth assumption used for the amortization of DPAC. The DPAC of nonparticipating term life insurance and individual disability policies are being amortized over the premium-paying period of the related policies using assumptions consistent with those used in computing policyholder liabilities.

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

DPAC 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. If loss recognition is necessary, DPAC would be 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.

Deferred Policy Acquisition Costs on Internal Replacements

All insurance and investment contract modifications and replacements are reviewed to determine if the internal replacement results in a substantially changed contract. If so, the acquisition costs, sales inducements and unearned revenue associated with the new contract are deferred and amortized over the lifetime of the new contract. In addition, the existing DPAC, sales inducement costs and unearned revenue balances associated with the replaced contract are written off. If an internal replacement results in a substantially unchanged contract, the acquisition costs, sales inducements and unearned revenue associated with the new contract are immediately recognized in the period incurred. In addition, the existing DPAC, sales inducement costs or unearned revenue balance associated with the replaced contract is not written off, but instead is carried over to the new contract.

Long-Term Debt

Long-term debt includes notes payable, nonrecourse mortgages and other debt with a maturity date greater than one year at the date of issuance. Current maturities of long-term debt are classified as long-term debt in our statement of financial position.

Reinsurance

We enter into reinsurance agreements with other companies in the normal course of business. We may assume reinsurance from or cede reinsurance to other companies. Assets and liabilities related to reinsurance ceded are reported on a gross basis. Premiums and expenses are reported net of reinsurance ceded. The cost of reinsurance related to long-duration contracts is accounted for over the life of the underlying reinsured policies using assumptions consistent with those used to account for the underlying policies. We are contingently liable with respect to reinsurance ceded to other companies in the event the reinsurer is unable to meet the obligations it has assumed. At December 31, 2011 and 2010, our largest exposures to a single third-party reinsurer in our individual life insurance business was $25.3 billion and $23.3 billion of life insurance in force, representing 16% and 15% of total net individual life insurance in force, respectively. The reinsurance recoverable related to this single third party reinsurer recorded in our consolidated statements of financial position was $22.6 million and $27.5 million at December 31, 2011 and 2010, respectively.

The effects of reinsurance on premiums and other considerations and policy and contract benefits were as follows:

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in millions)	
Premiums and other considerations:			
Direct	**$ 3,208.0**	$ 3,859.8	$ 4,047.6
Assumed	**3.0**	3.5	5.2
Ceded	**(320.0)**	(307.8)	(302.2)
Net premiums and other considerations	**$ 2,891.0**	$ 3,555.5	$ 3,750.6
Benefits, claims and settlement expenses:			
Direct	**$ 4,842.7**	$ 5,507.2	$ 5,564.5
Assumed	**34.3**	36.8	38.9
Ceded	**(422.9)**	(205.6)	(268.9)
Net benefits, claims and settlement expenses	**$ 4,454.1**	$ 5,338.4	$ 5,334.5

Separate Accounts

The separate account assets presented in the consolidated financial statements represent the fair value of funds that are separately administered by us for contracts with equity, real estate and fixed income investments. The separate account contract owner, rather than us, bears the investment risk of these funds. The separate account assets are legally segregated and are not subject to claims that arise out of any of our other business. We receive fees for mortality, withdrawal and expense risks, as well as administrative, maintenance and investment advisory services that are included in the consolidated statements of operations. Net deposits, net investment income and realized and unrealized capital gains and losses on the separate accounts are not reflected in the consolidated statements of operations.

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

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

At December 31, 2011 and 2010, the separate accounts include a separate account valued at $146.5 million and $221.7 million, respectively, which primarily includes shares of our stock that were allocated and issued to eligible participants of qualified employee benefit plans administered by us as part of the policy credits issued under our 2001 demutualization. These shares are included in both basic and diluted earnings per share calculations. In the consolidated statements of financial position, the separate account shares are recorded at fair value and are reported as separate account assets with a corresponding separate account liability to eligible participants of the qualified plan. Changes in fair value of the separate account shares are reflected in both the separate account assets and separate account liabilities and do not impact our results of operations.

Income Taxes

We file a U.S. consolidated income tax return that includes all of our qualifying subsidiaries. In addition, we file income tax returns in all states and foreign jurisdictions in which we conduct business. Our policy of allocating income tax expenses and benefits to companies in the group is generally based upon pro rata contribution of taxable income or operating losses. We are taxed at corporate rates on taxable income based on existing tax laws. Current income taxes are charged or credited to net income based upon amounts estimated to be payable or recoverable as a result of taxable operations for the current year. Deferred income taxes are provided for the tax effect of temporary differences in the financial reporting and income tax bases of assets and liabilities and net operating losses using enacted income tax rates and laws. The effect on deferred income tax assets and deferred income tax liabilities of a change in tax rates is recognized in operations in the period in which the change is enacted.

Foreign Exchange

Assets and liabilities of our foreign subsidiaries and affiliates denominated in non-U.S. dollars, where the U.S. dollar is not the functional currency, are translated into U.S. dollar equivalents at the year-end spot foreign exchange rates. Resulting translation adjustments are reported as a component of stockholders' equity, along with any related hedge and tax effects. Revenues and expenses for these entities are translated at the average exchange rates for the year. Revenue, expense and other foreign currency transaction and translation adjustments that affect cash flows are reported in net income, along with related hedge and tax effects.

Goodwill and Other Intangibles

Goodwill and other intangible assets include the cost of acquired subsidiaries in excess of the fair value of the net tangible assets recorded in connection with acquisitions. Goodwill and indefinite-lived intangible assets are not amortized. Rather, they are tested for impairment during the fourth quarter each year, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Goodwill is tested at the reporting unit level to which it was assigned. A reporting unit is an operating segment or a business one level below that operating segment, if financial information is prepared and regularly reviewed by management at that level. Once goodwill has been assigned to a reporting unit, it is no longer associated with a particular acquisition; therefore, all of the activities within a reporting unit, whether acquired or organically grown, are available to support the goodwill value. Impairment testing for indefinite-lived intangible assets consists of a comparison of the fair value of the intangible asset with its carrying value.

Intangible assets with a finite useful life 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.

Earnings Per Common Share

Basic earnings per common share is calculated by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period and excludes the dilutive effect of equity awards. Diluted earnings per common share reflects the potential dilution that could occur if dilutive securities, such as options and non-vested stock grants, were exercised or resulted in the issuance of common stock.

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

2. Goodwill and Other Intangible Assets

Goodwill

The changes in the carrying amount of goodwill reported in our segments were as follows:

	Retirement and Investor Services	Principal Global Investors	Principal International	U.S. Insurance Solutions	Corporate	Consolidated
			(in millions)			
Balances at January 1, 2010	$ 72.6	$ 169.0	$ 56.3	$ 43.4	$ 45.1	$ 386.4
Impairment					(43.6)	(43.6)
Foreign currency translation			4.2			4.2
Other			(1.6)			(1.6)
Balances at December 31, 2010	72.6	169.0	58.9	43.4	1.5	345.4
Goodwill from acquisitions		**68.0**	**86.2**			**154.2**
Foreign currency translation			**(17.3)**			**(17.3)**
Other				**1.5**	**(1.5)**	
Balances at December 31, 2011	**$ 72.6**	**$ 237.0**	**$ 127.8**	**$ 44.9**	**$**	**$ 482.3**

On September 30, 2010, we announced our decision to exit the group medical insurance business. This event constituted a substantive change in circumstances that would more likely than not reduce the fair value of our group medical insurance reporting unit below its carrying amount. Accordingly, we performed an interim goodwill impairment test as of September 30, 2010. As a result of the shortened period of projected cash flows, we determined that the goodwill related to this reporting unit within our Corporate operating segment was impaired and it was written down to a value of zero. We recorded a $43.6 million pre-tax impairment loss as an operating expense in the consolidated statements of operations during the year ended December 31, 2010.

Finite Lived Intangible Assets

Amortized intangible assets that continue to be subject to amortization over a weighted average remaining expected life of 13 years were as follows:

	December 31,					
	2011			2010		
	Gross carrying amount	Accumulated amortization	Net carrying amount	Gross carrying amount	Accumulated amortization	Net carrying amount
			(in millions)			
Present value of future profits	**$ 191.7**	**$ 47.9**	**$ 143.8**	$ 148.7	$ 48.7	$ 100.0
Other finite lived intangible assets	**218.9**	**139.3**	**79.6**	194.3	128.5	65.8
Total amortized intangible assets	**$ 410.6**	**$ 187.2**	**$ 223.4**	$ 343.0	$ 177.2	$ 165.8

During 2010, we fully amortized other finite lived intangible assets of $1.7 million. We had no fully amortized other finite lived intangible assets in 2011.

Present Value of Future Profits. Present value of future profits ("PVFP") represents the present value of estimated future profits to be generated from existing insurance contracts in-force at the date of acquisition and is amortized over the expected policy or contract duration in relation to estimated gross profits. The PVFP asset and amortization may be adjusted if revisions to estimated gross profits occur.

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

2. Goodwill and Other Intangible Assets (continued)

The changes in the carrying amount of PVFP, reported in our Principal International segment were as follows (in millions):

Balance at January 1, 2009	$ 84.4
Interest accrued	7.6
Amortization	(8.9)
Foreign currency translation	5.1
Other	10.2
Balance at December 31, 2009	98.4
Interest accrued	8.0
Amortization	(11.5)
Foreign currency translation	5.1
Balance at December 31, 2010	100.0
Acquisitions	**67.4**
Interest accrued	**9.4**
Amortization	**(14.2)**
Foreign currency translation	**(18.8)**
Balance at December 31, 2011	**$ 143.8**

At December 31, 2011, the estimated amortization expense, net of interest accrued, related to PVFP for the next five years is as follows (in millions):

Year ending December 31:	
2012	**$ 2.2**
2013	**2.3**
2014	**3.3**
2015	**4.3**
2016	**5.2**

Other Finite Lived Intangible Assets. During 2010, we recorded a $1.6 million pre-tax impairment loss as an operating expense related to finite lived intangible assets with a gross carrying amount of $6.0 million and $4.4 million of accumulated amortization at the time of impairment resulting from our decision to exit the group medical insurance business. During 2009, we recognized an impairment of $6.5 million associated with a customer-based intangible acquired as part of our acquisition of WM Advisors, Inc. This impairment had no impact on our consolidated statement of operations for the Retirement and Investor Services segment, as the cash flows associated with this intangible are credited to an outside party.

The amortization expense for intangible assets with finite useful lives was $11.3 million, $18.9 million and $35.2 million for 2011, 2010 and 2009, respectively. At December 31, 2011, the estimated amortization expense for the next five years is as follows (in millions):

Year ending December 31:	
2012	**$ 13.3**
2013	**11.5**
2014	**10.5**
2015	**8.9**
2016	**8.8**

Indefinite Lived Intangible Assets

The net carrying amount of unamortized indefinite lived intangible assets was $667.2 million and $668.8 million as of December 31, 2011 and 2010, respectively. As of both December 31, 2011 and 2010, $608.0 million relates to investment management contracts associated with our December 31, 2006, acquisition of WM Advisors, Inc.

3. Variable Interest Entities

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

3. Variable Interest Entities (continued)

Consolidated Variable Interest Entities

Grantor Trusts

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

Collateralized Private Investment Vehicles

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

Commercial Mortgage-Backed Securities

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

Hedge Funds

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

3. Variable Interest Entities (continued)

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

	Grantor trusts	Collateralized private investment vehicles	CMBS	Hedge funds (2)	Total
		(in millions)			
December 31, 2011					
Fixed maturities, available-for-sale	**$ 199.2**	**$ 15.0**	**$**	**$**	**$ 214.2**
Fixed maturities, trading		**132.4**			**132.4**
Equity securities, trading				**207.6**	**207.6**
Other investments			**97.5**	**0.3**	**97.8**
Cash and cash equivalents				**317.7**	**317.7**
Accrued investment income	**1.2**	**0.1**	**0.6**		**1.9**
Premiums due and other receivables				**39.1**	**39.1**
Total assets	**$ 200.4**	**$ 147.5**	**$ 98.1**	**$ 564.7**	**$ 1,010.7**
Deferred income taxes	**$ 2.2**	**$**	**$**	**$**	**$ 2.2**
Other liabilities (1)	**136.9**	**143.8**	**64.5**	**220.0**	**565.2**
Total liabilities	**$ 139.1**	**$ 143.8**	**$ 64.5**	**$ 220.0**	**$ 567.4**
December 31, 2010					
Fixed maturities, available-for-sale	$ 243.1	$ 14.8	$	$	$ 257.9
Fixed maturities, trading		131.4			131.4
Equity securities, trading				158.6	158.6
Other investments			128.4	0.3	128.7
Cash and cash equivalents		55.0		45.0	100.0
Accrued investment income	0.7	0.1	0.8		1.6
Premiums due and other receivables		1.6		13.9	15.5
Total assets	$ 243.8	$ 202.9	$ 129.2	$ 217.8	$ 793.7
Deferred income taxes	$ 2.4	$	$	$	$ 2.4
Other liabilities (1)	135.8	132.6	94.1	71.1	433.6
Total liabilities	$ 138.2	$ 132.6	$ 94.1	$ 71.1	$ 436.0

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

(2) The consolidated statements of financial position included a $343.6 million and $145.9 million noncontrolling interest for hedge funds as of December 31, 2011 and December 31, 2010, respectively.

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

Unconsolidated Variable Interest Entities

Invested Securities

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

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

3. Variable Interest Entities (continued)

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

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

We have invested in partnerships, some of which are classified as VIEs. The partnership returns are in the form of return of capital, interest income or income tax credits. These entities are classified as VIEs as the general partner does not have an equity investment at risk in the entity. We have determined we are not the primary beneficiary because we are not the general partner, who makes all the significant decisions for the entity.

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

	Asset carrying value	Maximum exposure to loss (1)
	(in millions)	
December 31, 2011		
Fixed maturities, available-for-sale:		
Corporate	**$ 544.0**	**$ 392.6**
Residential mortgage-backed pass-through securities	**3,343.0**	**3,155.8**
Commercial mortgage-backed securities	**3,413.7**	**3,894.3**
Collateralized debt obligations	**338.8**	**399.7**
Other debt obligations	**3,570.2**	**3,606.9**
Fixed maturities, trading:		
Residential mortgage-backed pass-through securities	**105.6**	**105.6**
Commercial mortgage-backed securities	**12.0**	**12.0**
Collateralized debt obligations	**51.4**	**51.4**
Other debt obligations	**64.9**	**64.9**
Other investments:		
Other limited partnership interests	**76.3**	**76.3**
December 31, 2010		
Fixed maturities, available-for-sale:		
Corporate	$ 429.0	$ 367.7
Residential mortgage-backed pass-through securities	3,196.2	3,077.9
Commercial mortgage-backed securities	3,842.2	4,424.9
Collateralized debt obligations	293.0	380.5
Other debt obligations	3,114.1	3,184.9
Fixed maturities, trading:		
Residential mortgage-backed pass-through securities	215.5	215.5
Commercial mortgage-backed securities	5.1	5.1
Collateralized debt obligations	87.2	87.2
Other debt obligations	118.8	118.8
Other investments:		
Other limited partnership interests	71.7	71.7

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

Sponsored Investment Funds

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

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

4. Investments

Fixed Maturities and Equity Securities

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

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Other-than-temporary impairments in AOCI (1)	Fair value
			(in millions)		
December 31, 2011					
Fixed maturities, available-for-sale:					
U.S. government and agencies	**$ 772.3**	**$ 32.8**	**$**	**$**	**$ 805.1**
Non-U.S. governments	**917.6**	**180.5**	**1.4**		**1,096.7**
States and political subdivisions	**2,670.0**	**218.2**	**5.5**		**2,882.7**
Corporate	**31,954.1**	**2,321.3**	**699.5**	**19.4**	**33,556.5**
Residential mortgage-backed pass-through securities	**3,155.8**	**187.9**	**0.7**		**3,343.0**
Commercial mortgage-backed securities	**3,894.3**	**117.0**	**429.4**	**168.2**	**3,413.7**
Collateralized debt obligations	**399.7**	**1.9**	**55.8**	**7.0**	**338.8**
Other debt obligations	**3,606.9**	**100.3**	**47.0**	**90.0**	**3,570.2**
Total fixed maturities, available-for-sale	**$ 47,370.7**	**$ 3,159.9**	**$ 1,239.3**	**$ 284.6**	**$ 49,006.7**
Total equity securities, available-for-sale	**$ 74.9**	**$ 8.7**	**$ 6.5**		**$ 77.1**
December 31, 2010					
Fixed maturities, available-for-sale:					
U.S. government and agencies	$ 748.5	$ 21.0	$ 0.2	$	$ 769.3
Non-U.S. governments	744.7	127.9			872.6
States and political subdivisions	2,615.0	64.7	23.3		2,656.4
Corporate	32,523.8	1,913.7	527.0	18.0	33,892.5
Residential mortgage-backed pass-through securities	3,077.9	124.2	5.9		3,196.2
Commercial mortgage-backed securities	4,424.9	118.0	506.1	194.6	3,842.2
Collateralized debt obligations	380.5	1.7	51.8	37.4	293.0
Other debt obligations	3,184.9	53.7	40.0	84.5	3,114.1
Total fixed maturities, available-for-sale	$ 47,700.2	$ 2,424.9	$ 1,154.3	$ 334.5	$ 48,636.3
Total equity securities, available-for-sale	$ 180.0	$ 8.1	$ 18.2		$ 169.9

(1) Excludes $28.9 million and $58.6 million as of December 31, 2011 and 2010, respectively, of net unrealized gains on impaired fixed maturities, available-for-sale related to changes in fair value subsequent to the impairment date.

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

Amortized cost	Fair value
(in millions)	

Due in one year or less	$	**3,006.4**	$	**3,044.9**
Due after one year through five years		**13,045.7**		**13,476.7**
Due after five years through ten years		**9,166.0**		**9,860.2**
Due after ten years		**11,095.9**		**11,959.2**
Subtotal		**36,314.0**		**38,341.0**
Mortgage-backed and other asset-backed securities		**11,056.7**		**10,665.7**
Total	$	**47,370.7**	$	**49,006.7**

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

Net Investment Income

Major categories of net investment income are summarized as follows:

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in millions)	
Fixed maturities, available-for-sale	**$ 2,596.2**	$ 2,702.1	$ 2,679.3
Fixed maturities, trading	**64.7**	92.6	37.9
Equity securities, available-for-sale	**10.5**	11.4	16.8
Equity securities, trading	**4.4**	2.8	2.5
Mortgage loans	**649.2**	673.3	688.9
Real estate	**74.2**	57.5	35.9
Policy loans	**58.2**	60.9	62.0
Cash and cash equivalents	**8.5**	7.2	13.0
Derivatives	**(196.1)**	(174.4)	(128.3)
Other	**189.0**	152.6	104.3
Total	**3,458.8**	3,586.0	3,512.3
Investment expenses	**(83.0)**	(89.5)	(111.5)
Net investment income	**$ 3,375.8**	$ 3,496.5	$ 3,400.8

Net Realized Capital Gains and Losses

The major components of net realized capital gains (losses) on investments are summarized as follows:

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in millions)	
Fixed maturities, available-for-sale:			
Gross gains	**$ 26.4**	$ 63.7	$ 123.3
Gross losses	**(158.8)**	(339.9)	(703.9)
Other-than-temporary impairment losses reclassified to (from) OCI	**(49.7)**	56.1	260.9
Hedging, net	**130.5**	142.2	(229.1)
Fixed maturities, trading	**(6.7)**	17.5	49.3
Equity securities, available-for-sale:			
Gross gains	**2.2**	8.9	27.0
Gross losses	**(6.4)**	(3.2)	(46.5)
Equity securities, trading	**20.3**	27.7	39.4
Mortgage loans	**(42.1)**	(152.2)	(153.6)
Derivatives	**(180.5)**	(143.9)	263.3
Other	**142.5**	131.6	(28.4)
Net realized capital losses	**$ (122.3)**	$ (191.5)	$ (398.3)

Proceeds from sales of investments (excluding call and maturity proceeds) in fixed maturities, available-for-sale were $0.9 billion, $1.6 billion and $3.3 billion in 2011, 2010 and 2009, respectively.

Other-Than-Temporary Impairments

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

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

period of time that allows for the recovery in value. To the extent we determine that a security is deemed to be other than temporarily impaired, an impairment loss is recognized.

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

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

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in millions)	
Fixed maturities, available-for-sale	**$ (143.8)**	$ (300.0)	$ (693.6)
Equity securities, available-for-sale	**(3.8)**	3.7	(20.5)
Total other-than-temporary impairment losses, net of recoveries from the sale of previously impaired securities	**(147.6)**	(296.3)	(714.1)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) OCI (1)	**(49.7)**	56.1	260.9
Net impairment losses on available-for-sale securities	**$ (197.3)**	$ (240.2)	$ (453.2)

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

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

The following table provides a rollforward of accumulated credit losses for fixed maturities with bifurcated credit losses. The purpose of the table is to provide detail of (1) additions to the bifurcated credit loss amounts recognized in net realized capital gains (losses) during the period and (2) decrements for previously recognized bifurcated credit losses

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

where the loss is no longer bifurcated and/or there has been a positive change in expected cash flows or accretion of the bifurcated credit loss amount.

	For the year ended December 31,		
	2011	**2010**	**2009**
		(in millions)	
Beginning balance	**$ (325.7)**	$ (204.7)	$ (18.5)
Credit losses for which an other-than-temporary impairment was not previously recognized	**(37.8)**	(112.4)	(168.5)
Credit losses for which an other-than-temporary impairment was previously recognized	**(135.6)**	(109.7)	(52.7)
Reduction for credit losses previously recognized on fixed maturities now sold or intended to be sold	**68.2**	53.2	33.4
Reduction for credit losses previously recognized on fixed maturities reclassified to trading (1)		44.4	
Net reduction (increase) for positive changes in cash flows expected to be collected and amortization (2)	**(3.9)**	3.5	1.6
Ending balance	**$ (434.8)**	$ (325.7)	$ (204.7)

(1) Fixed maturities previously classified as available-for-sale have been reclassified to trading as a result of electing the fair value option upon adoption of accounting guidance related to the evaluation of credit derivatives embedded in beneficial interests in securitized financial assets.

(2) Amounts are recognized in net investment income.

Gross Unrealized Losses for Fixed Maturities and Equity Securities

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

	December 31, 2011					
	Less than twelve months		Greater than or equal to twelve months		Total	
	Carrying value	**Gross unrealized losses**	**Carrying value**	**Gross unrealized losses**	**Carrying value**	**Gross unrealized losses**
			(in millions)			
Non-U.S. governments	**$ 68.5**	**$ 1.4**	**$ 0.3**	**$**	**$ 68.8**	**$ 1.4**
States and political subdivisions	**5.7**	**0.1**	**51.7**	**5.4**	**57.4**	**5.5**
Corporate	**3,445.6**	**140.8**	**2,403.9**	**578.1**	**5,849.5**	**718.9**
Residential mortgage-backed pass-through securities	**77.8**	**0.5**	**3.7**	**0.2**	**81.5**	**0.7**
Commercial mortgage-backed securities	**608.4**	**57.3**	**858.9**	**540.3**	**1,467.3**	**597.6**
Collateralized debt obligations	**107.2**	**2.5**	**204.4**	**60.3**	**311.6**	**62.8**
Other debt obligations	**708.1**	**13.0**	**508.1**	**124.0**	**1,216.2**	**137.0**
Total fixed maturities, available-for-sale	**$ 5,021.3**	**$ 215.6**	**$ 4,031.0**	**$ 1,308.3**	**$ 9,052.3**	**$ 1,523.9**
Total equity securities, available-for-sale	**$ 14.3**	**$ 3.2**	**$ 15.6**	**$ 3.3**	**$ 29.9**	**$ 6.5**

Of the total amounts, Principal Life's consolidated portfolio represented $8,540.7 million in available-for-sale fixed maturities with gross unrealized losses of $1,470.3 million. Principal Life's consolidated portfolio consists of fixed maturities where 76% were investment grade (rated AAA through BBB-) with an average price of 85 (carrying value/amortized cost) at December 31, 2011. Gross unrealized losses in our fixed maturities portfolio increased slightly during the year ended December 31, 2011, due to a widening of credit spreads primarily in the corporate and commercial mortgage-backed securities sectors.

For those securities that had been in a continuous unrealized loss position for less than twelve months, Principal Life's consolidated portfolio held 477 securities with a carrying value of $4,573.6 million and unrealized losses of $198.7 million reflecting an average price of 96 at December 31, 2011. Of this portfolio, 86% was investment grade (rated AAA through BBB-) at December 31, 2011, with associated unrealized losses of $128.5 million. The unrealized losses on these securities can primarily be attributed to changes in market interest rates and changes in credit spreads since the securities were acquired.

For those securities that had been in a continuous unrealized loss position greater than or equal to twelve months, Principal Life's consolidated portfolio held 628 securities with a carrying value of $3,967.1 million and unrealized losses of

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

$1,271.6 million. The average rating of this portfolio was BBB with an average price of 76 at December 31, 2011. Of the $1,271.6 million in unrealized losses, the commercial mortgage-backed securities sector accounts for $540.3 million in unrealized losses with an average price of 61 and an average credit rating of BBB-. The remaining unrealized losses consist primarily of $541.4 million within the corporate sector at December 31, 2011. The average price of the corporate sector was 81 and the average credit rating was BBB. The unrealized losses on these securities can primarily be attributed to changes in market interest rates and changes in credit spreads since the securities were acquired.

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

	December 31, 2010					
	Less than twelve months		Greater than or equal to twelve months		Total	
	Carrying value	Gross unrealized losses	Carrying value	Gross unrealized losses	Carrying value	Gross unrealized losses
	(in millions)					
Fixed maturities, available-for-sale:						
U.S. government and agencies	$ 224.5	$ 0.2	$	$	$ 224.5	$ 0.2
Non-U.S. governments	7.9				7.9	
States and political subdivisions	771.0	18.4	44.2	4.9	815.2	23.3
Corporate	2,457.4	69.1	3,948.9	475.9	6,406.3	545.0
Residential mortgage-backed pass-through securities	384.9	5.9			384.9	5.9
Commercial mortgage-backed securities	340.1	4.9	1,186.4	695.8	1,526.5	700.7
Collateralized debt obligations	10.4	0.5	233.0	88.7	243.4	89.2
Other debt obligations	401.5	8.4	578.4	116.1	979.9	124.5
Total fixed maturities, available-for-sale	$ 4,597.7	$ 107.4	$ 5,990.9	$ 1,381.4	$ 10,588.6	$ 1,488.8
Total equity securities, available-for-sale	$ 47.3	$ 7.2	$ 77.0	$ 11.0	$ 124.3	$ 18.2

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

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

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

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

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

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

	December 31, 2011	December 31, 2010
	(in millions)	
Net unrealized gains on fixed maturities, available-for-sale (1)	**$ 1,920.6**	$ 1,197.7
Noncredit component of impairment losses on fixed maturities, available-for-sale	**(284.6)**	(334.5)
Net unrealized gains (losses) on equity securities, available-for-sale	**2.2**	(10.1)
Adjustments for assumed changes in amortization patterns	**(454.2)**	(273.8)
Adjustments for assumed changes in policyholder liabilities	**(442.7)**	(212.4)
Net unrealized gains on derivative instruments	**113.1**	53.5
Net unrealized gains on equity method subsidiaries and noncontrolling interest adjustments	**150.4**	145.2
Provision for deferred income taxes	**(327.0)**	(169.0)
Effects of implementation of accounting change related to variable interest entities, net		10.7
Effects of electing fair value option for fixed maturities upon implementation of accounting changes related to embedded credit derivatives, net		25.4
Net unrealized gains on available-for-sale securities and derivative instruments	**$ 677.8**	$ 432.7

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

Mortgage Loans

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

	December 31, 2011	December 31, 2010
	(in millions)	
Commercial mortgage loans	**$ 9,461.4**	$ 9,689.6
Residential mortgage loans	**1,367.9**	1,556.6
Total amortized cost	**10,829.3**	11,246.2
Valuation allowance	**(102.1)**	(121.1)
Total carrying value	**$ 10,727.2**	$ 11,125.1

We periodically purchase mortgage loans as well as sell mortgage loans we have originated. We purchased $101.0 million and $39.8 million of residential mortgage loans during the years ended December 31, 2011 and 2010, respectively. We sold $18.4 million and

$17.4 million of residential mortgage loans and zero and $34.1 million of commercial mortgage loans during the years ended December 31, 2011 and 2010, respectively.

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

Table of Contents

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

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

	December 31,			
	2011		2010	
	Amortized cost	Percent of total	Amortized cost	Percent of total
	($ in millions)			
Geographic distribution				
New England	**$ 454.0**	**4.8%**	$ 430.3	4.5%
Middle Atlantic	**1,744.4**	**18.4**	1,648.4	17.0
East North Central	**774.8**	**8.2**	841.1	8.7
West North Central	**407.8**	**4.3**	466.7	4.8
South Atlantic	**2,099.8**	**22.2**	2,358.1	24.3
East South Central	**231.8**	**2.4**	231.5	2.4
West South Central	**648.6**	**6.9**	548.6	5.7
Mountain	**643.2**	**6.8**	691.0	7.1
Pacific	**2,446.4**	**25.9**	2,464.5	25.4
International	**10.6**	**0.1**	9.4	0.1
Total	**$ 9,461.4**	**100.0%**	$ 9,689.6	100.0%
Property type distribution				
Office	**$ 2,753.8**	**29.1%**	$ 2,886.2	29.8%
Retail	**2,580.2**	**27.3**	2,503.0	25.8
Industrial	**2,070.7**	**21.9**	2,334.5	24.1
Apartments	**1,242.9**	**13.1**	1,138.1	11.7
Hotel	**467.7**	**4.9**	471.8	4.9
Mixed use/other	**346.1**	**3.7**	356.0	3.7
Total	**$ 9,461.4**			

Annaly Commercial Real Estate Group
Originates and invests in commercial mortgage loans, securities, and other commercial real estate debt and equity investments.
Annaly Middle Market Lending Group
Provides financing to private equity-backed middle market businesses across the capital structure.

For a full discussion of our business, refer to the section titled "Business Overview" in our most recent Annual Report on Form 10-K.

Pending Acquisition of MTGE Investment Corp.

As previously disclosed in a Form 8-K filed with the SEC on May 3, 2018 (the "Merger 8-K"), on May 2, 2018, Annaly, Mountain Merger Sub Corporation, a wholly-owned subsidiary of Annaly ("Purchaser"), and MTGE Investment Corp. ("MTGE") entered into an agreement and plan of merger (the "Merger Agreement"), pursuant to which, subject to the terms and conditions contained therein, we agreed to acquire MTGE (the "MTGE Acquisition"), an externally managed hybrid mortgage REIT, for aggregate consideration to MTGE common shareholders of approximately $900.0 million based on the closing price of Annaly's common stock on April 30, 2018. Approximately 50% of such consideration will be payable in shares of our common stock, and approximately 50% of which will be payable in cash. Purchaser will commence an exchange offer (the "Offer") to purchase all of MTGE's issued and outstanding shares of common stock and, upon the closing of the Offer, subject to customary closing conditions as set forth in the Merger Agreement, MTGE will be merged with and into Purchaser (the “Merger”), with Purchaser surviving the Merger. In addition, as part of the MTGE Acquisition, each share of MTGE 8.125% Series A Cumulative Redeemable Preferred Stock, par value $0.01 per share (each, a “MTGE Preferred Share”), that is outstanding as of immediately prior to the completion of the MTGE Acquisition will be converted into one share of a newly-designated series of our preferred stock, par value $0.01 per share, which we expect will be classified and designated as 8.125% Series H Cumulative Redeemable Preferred Stock, and which will have rights, preferences,

privileges and voting powers substantially the same as a MTGE Preferred Share.

The closing of the MTGE Acquisition is subject to a number of conditions, including the receipt of specified regulatory approvals.

Prior to closing the MTGE Acquisition, MTGE will declare a prorated common dividend to its stockholders with a record date on the fourth business day prior to the completion of the Offer, and payable upon the date of the completion of the Offer. In addition, we expect to declare and pay a prorated common dividend to our stockholders, with a record date on the last business day prior to the completion of the Offer. Each of the dividends will be prorated based on the number of days that elapsed since the record date for the most recent quarterly dividend paid to MTGE’s and Annaly’s stockholders, respectively, and the amount of such prior quarterly dividend, as applicable.

The MTGE Acquisition is expected to be completed during the third quarter of 2018.

For additional details regarding the terms and conditions of the Merger Agreement and related matters, please refer to the Merger Agreement and the Merger 8-K and the other documentation filed as exhibits thereto. Additional information regarding the transactions contemplated by the Merger Agreement, including associated risks, will be contained in a registration statement on Form S-4 that we expect to file with the SEC in connection with the MTGE Acquisition.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management’s Discussion And Analysis

Business Environment

The three months ended March 31, 2018 presented a challenging environment driven by a number of macro-economic factors: interest rate levels rose as a result of stabilized inflation readings, a deterioration in the United States debt outlook, and signaling from the Federal Reserve of continued gradual increases in the Federal Funds Target Rate. In addition, volatility returned to the equity, credit, and rate markets as investors began to pay closer attention to increased political uncertainty and began to more actively differentiate among risk factors in the market. In this environment, we focused on positioning the portfolio to not only withstand a challenging short-term market environment, but to continue to provide value for our shareholders for the long-term. We proactively lowered economic leverage, increased our hedge ratio, enhanced our financing and continued to selectively diversify into credit assets. We believe this more defensive stance positions us to take advantage of the opportunities that an altered environment will present in the quarters ahead. Meanwhile, we will continue our disciplined approach to growing our credit businesses as the credit sector continues to be fully valued in general, while we avoid investment opportunities where we are uncomfortable with the credit fundamentals or credit protection.

Economic Environment

The pace of economic growth slowed in the three months ended March 31, 2018, coming in near estimated potential growth. Measured by real gross domestic product (“GDP”), activity increased by an annualized 2.3% during the three months ended March 31, 2018, slightly lower from 2.6% of growth in 2017. The decline was due to a reversion of personal consumption rate to an annualized rate of only 1.1% during the three months ended March 31, 2018 compared to 2.9% in 2017. Consumer spending patterns in 2017 were marked by a lowering of the personal saving rate as wealth rose and a temporary boost due to replacement of hurricane-damaged items during the three months ended December 31, 2017, with both patterns reversing during the three months ended March 31, 2018. Non-residential investment remained healthy, with firms investing at a 6.1% rate compared to 6.3% last year on the back of higher oil prices, lowered tax burdens and rising labor costs. Residential investment remained very weak, only expanding by a negligible 0.1% during the three months ended March 31, 2018 after experiencing a modest 2.6% growth in 2017. The trade balance reversed to boost GDP growth, adding 0.2% to the growth rate during the three months ended March 31, 2018, compared to a (1.2%) drag in 2017 as U.S. goods imports pulled back sharply which was in line with temporarily weaker spending.

The Federal Reserve System (“Fed”) currently conducts monetary policy with a dual mandate: full employment and price stability. The unemployment rate remained unchanged in the first quarter of 2018 at 4.1%, remaining below the Fed’s

estimate of the long-run unemployment rate of 4.5%, according to the Bureau of Labor Statistics and Federal Reserve Board. The economy added 202,000 jobs per month during the three months ended March 31, 2018, slightly up from 182,000 jobs added per month in 2017. Labor force growth has increased recently, averaging 389,000 per month in 2018 as higher wages have appeared to increase prime age (25-54 year old) participation rates. Wage growth, as measured by the year-over-year change in Average Hourly Earnings, has rebounded to 2.72% as of March 2018 compared to 2.66% in December 2017 and a recent low of 2.28% in October 2017. The Fed sees labor markets continuing to improve in 2018, projecting the unemployment rate to drop to 3.8% as of their March 21, 2018 economic projections.

Inflation remained below the Fed’s 2% target during the three months ended March 31, 2018, as measured by the year-over-year changes in the Personal Consumer Expenditure Chain Price Index (“PCE”). The headline PCE measure increased by 2.0% year-over-year in March 2018, up slightly from 1.70% in December 2017. The more stable core PCE measure, which excludes volatile food and energy prices, rebounded to 1.88% in March 2018 compared to 1.52%

in December 2017, as early 2018 weakness fell off the year-over-year comparison. The Fed expects both the core and headline PCE measures to increase by 1.9% year-over-year by the fourth quarter of 2018, before core PCE rises above its target to 2.1% in the fourth quarter of 2019 where it is expected to remain in 2020.

The Federal Open Market Committee ("FOMC") continued to support its dual mandate by keeping its target for the federal funds rate at accommodative levels, while gradually reducing the size of its portfolio of U.S. Treasury and Agency mortgage-backed securities holdings. In assessing realized and expected progress towards its objectives, the FOMC kept the target range for the federal funds rate unchanged at 1.25%-1.50% at its January 31, 2018 meeting before raising it to 1.50%-1.75% at its March 21, 2018 meeting. Continued labor market and inflation improvement led the FOMC to keep its economic outlook optimistic, with fiscal stimulus via tax cuts and increased federal spending leading to an upward growth assessment in the forecasts of the March 2018 meeting. In January 2018, the cap of portfolio runoff amount increased from $6.0 billion to $12.0 billion per month for U.S. Treasury securities and from $4.0 billion to $8.0 billion per month for Agency mortgage-backed securities. The program will be increased by the same amount every three months until maximum monthly runoff levels of $30.0 billion and $20.0 billion, respectively, are reached.

During the three months ended March 31, 2018, the 10-year U.S. Treasury Rate continued the sell-off that began in the fourth quarter of 2017 as fiscal stimulus drove growth sentiment and inflation expectations. Despite the sell-off, estimated measures of term premium, or the compensation required for purchasing longer-dated Treasury maturities, was roughly unchanged. The mortgage basis, or the spread between the 30-year Agency mortgage-backed security coupon and 10-year U.S. Treasury Rate, rose modestly,

according to Bloomberg, as investors began to recognize the Fed balance sheet run-off and increased volatility.

The following table presents interest rates at each date presented:

	March 31, 2018	December 31, 2017	March 31, 2017
30-Year mortgage current coupon	3.46%	3.00%	3.13%
Mortgage basis	72 bps	59 bps	75 bps
10-Year U.S. Treasury rate	2.74%	2.41%	2.39%
LIBOR:			
1-Month	1.88%	1.56%	0.98%
6-Month	2.45%	1.84%	1.42%

Results of Operations

The results of our operations are affected by various factors, many of which are beyond our control. Certain of such risks and uncertainties are described herein (see “Special Note Regarding Forward-Looking Statements” above) and in Part I, Item 1A. “Risk Factors” of our most recent annual report on Form 10-K.

This Management Discussion and Analysis section contains analysis and discussion of financial results computed in accordance with U.S. generally accepted accounting principles (“GAAP”) and non-GAAP measurements. To supplement our consolidated financial statements, which are

prepared and presented in accordance with GAAP, we provide non-GAAP financial measures to enhance investor understanding of our period-over-period operating performance and business trends, as well as for assessing our performance versus that of industry peers.

Please refer to the “Non-GAAP Financial Measures” section for additional information.

Net Income (Loss) Summary

The following table presents financial information related to our results of operations as of and for the three months ended March 31, 2018 and 2017.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

	For the Three Months Ended	
	March 31, 2018	March 31, 2017
	(dollars in thousands, except per share data)	
Interest income	$879,487	$587,727
Interest expense	367,421	198,425
Net interest income	512,066	389,302
Realized and unrealized gains (losses)	844,689	74,265
Other income (loss)	34,023	31,646
Less: General and administrative expenses	62,510	53,828
Income (loss) before income taxes	1,328,268	441,385
Income taxes	564	977
Net income (loss)	1,327,704	440,408
Net income (loss) attributable to noncontrolling interest	(96)	(103)
Net income (loss) attributable to Annaly	1,327,800	440,511
Dividends on preferred stock	33,766	23,473
Net income (loss) available (related) to common stockholders	$1,294,034	$417,038
Net income (loss) per share available (related) to common stockholders:		
Basic	$1.12	$0.41
Diluted	$1.12	$0.41
Weighted average number of common shares outstanding:		
Basic	1,159,617,848	1,018,942,746
Diluted	1,160,103,185	1,019,307,379
Other information:		
Asset portfolio at period-end	$98,080,871	$82,510,837
Average total assets	$101,071,142	$86,282,002
Average equity	$14,407,254	$12,611,661
Leverage at period-end (1)	6.1:1	5.6:1
Economic leverage at period-end (2)	6.5:1	6.1:1
Capital ratio (3)	13.1%	13.8%
Annualized return on average total assets	5.25%	2.04%
Annualized return (loss) on average equity	36.86%	13.97%
Annualized core return on average equity (excluding PAA) (4)	10.70%	10.66%
Net interest margin (5)	1.94%	1.47%
Net interest margin (excluding PAA) (4)	1.52%	1.55%
Average yield on interest earning assets	3.45%	2.74%
Average yield on interest earning assets (excluding PAA) (4)	2.99%	2.83%
Average cost of interest bearing liabilities (6)	1.90%	1.59%
Net interest spread	1.55%	1.15%
Net interest spread (excluding PAA) (4)	1.09%	1.24%
Constant prepayment rate	8.9%	11.5%
Long-term constant prepayment rate	9.2%	10.0%
Common stock book value per share	$10.53	$11.23
Interest income (excluding PAA) (4)	$761,092	$605,597
Economic interest expense (4) (6)	$415,581	$287,391
Economic net interest income (excluding PAA) (4)	$345,511	$318,206

Core earnings [4]	$503,667	$318,028
Premium amortization adjustment cost (benefit)	$(118,395)	$17,870
Core earnings (excluding PAA) [4]	$385,272	$335,898
Core earnings per common share [4]	$0.41	$0.29
PAA cost (benefit) per common share [4]	$(0.11)	$0.02
Core earnings (excluding PAA) per common share [4]	$0.30	$0.31

(1) Debt consists of repurchase agreements, other secured financing, securitized debt, participation sold and mortgages payable. Securitized debt, participation sold and mortgages payable are non-recourse to us.

(2) Computed as the sum of Recourse Debt, TBA derivative notional outstanding and net forward purchases of investments divided by total equity.

(3) Represents the ratio of stockholders' equity to total assets (inclusive of total market value of TBA derivatives and exclusive of securitized debt of consolidated VIEs).

(4) Represents a non-GAAP financial measure. Refer to the "Non-GAAP Financial Measures" section for additional information.

(5) Represents the sum of our interest income plus TBA dollar roll income less interest expense and realized gains (losses) on interest rate swaps divided by the sum of average Interest Earning Assets plus average outstanding TBA contract balances.

(6) Includes GAAP interest expense and interest expense on interest rate swaps. Prior to the three months ended March 31, 2018, this metric included interest expense on interest rate swaps used to hedge cost of funds. Beginning with the three months ended March 31, 2018, as a result of changes to our hedging portfolio, this metric reflects all interest expense on interest rate swaps, which is reported as Realized gains (losses) on interest rate swaps in the Consolidated Statements of Comprehensive Income (Loss).

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management’s Discussion And Analysis

GAAP

Net income (loss) was $1.3 billion, which includes ($0.1) million attributable to a noncontrolling interest, or $1.12 per average basic common share, for the three months ended March 31, 2018 compared to $440.4 million, which includes ($0.1) million attributable to a noncontrolling interest, or $0.41 per average basic common share, for the same period in 2017. We attribute the majority of the change in net income (loss) to increases in unrealized gains on interest rate swaps and net interest income, partially offset by the change in net unrealized gains (losses) on investments measured at fair value through earnings. Unrealized gains on interest rate swaps increased $828.1 million to $977.3 million for the three months ended March 31, 2018 compared to $149.2 million for the same period in 2017, reflecting a sharper rise in forward interest rates during the three months ended March 31, 2018 compared to the same period in 2017. Net interest income increased $122.8 million to $512.1 million for the three months ended March 31, 2018 compared to $389.3 million for the same period in 2017, primarily due to higher coupon income earned resulting from an increase in average Interest Earning Assets, partially offset by an increase in interest expense from higher rates and an increase in average Interest Bearing Liabilities. Net unrealized gains (losses) on investments measured at fair value through earnings were ($51.6) million for the three months ended March 31, 2018 compared to $23.7 million for the same period in 2017, primarily due to unfavorable changes in unrealized gains (losses) on Agency interest-only investments, non-Agency mortgage-backed securities and credit risk transfer securities, partially offset by favorable changes in unrealized gains (losses) on MSRs.

Non-GAAP

Core earnings (excluding premium amortization adjustment (“PAA”)) were $385.3 million, or $0.30 per average common share, for the three months ended March 31, 2018 compared to $335.9 million, or $0.31 per average common share, for the same period in 2017. Core earnings (excluding PAA) increased during the three months ended March 31, 2018 compared to the same period in 2017 primarily due to higher coupon income earned resulting from an increase in average Interest Earning Assets, higher TBA dollar roll income and lower interest expense on interest rate swaps, partially offset by an increase in interest expense from higher rates, an increase in average Interest Bearing Liabilities and higher amortization on MSRs.

Non-GAAP Financial Measures

To supplement our consolidated financial statements, which are prepared and presented in accordance with GAAP, we provide the following non-GAAP financial measures.

- core earnings and core earnings (excluding PAA);
- core earnings and core earnings (excluding PAA) per average common share;
- annualized core return on average equity (excluding PAA);

- interest income (excluding PAA);
- economic interest expense;
- economic net interest income (excluding PAA);
- average yield on Interest Earning Assets (excluding PAA);
- net interest margin (excluding PAA); and
- net interest spread (excluding PAA).

These measures should not be considered a substitute for, or superior to, financial measures computed in accordance with GAAP. While intended to offer a fuller understanding of our results and operations, non-GAAP financial measures also have limitations. For example, we may calculate our non-GAAP metrics, such as core earnings, or the PAA, differently than our peers making comparative analysis difficult. Additionally, in the case of non-GAAP measures that exclude the PAA, the amount of amortization expense excluding the PAA is not necessarily representative of the amount of future periodic amortization nor is it indicative of the term over which we will amortize the remaining unamortized premium. Changes to actual and estimated prepayments will impact the timing and amount of premium amortization and, as such, both GAAP and non-GAAP results.

These non-GAAP measures provide additional detail to enhance investor understanding of our period-over-period operating performance and business trends, as well as for assessing our performance versus that of industry peers. Additional information pertaining to our use of these non-GAAP financial measures, including discussion of how each such measure is useful to investors, and reconciliations to their most directly comparable GAAP results are provided below.

Amortization

In accordance with GAAP, we amortize or accrete premiums or discounts into interest income for our Agency mortgage-backed securities, excluding interest-only securities, taking into account estimates of future principal prepayments in the calculation of the effective yield. We recalculate the effective yield as differences between anticipated and actual prepayments occur. Using third-party model and market information to project future cash flows and expected remaining lives of securities, the effective interest rate determined for each security is applied as if it had been in place from the date of the security's acquisition. The amortized cost of the security is then adjusted to the amount that would have existed had the new effective yield been applied since the acquisition date. The adjustment to amortized cost is offset with a charge or credit to interest income. Changes in interest rates and other market factors will impact prepayment speed projections and the amount of premium amortization recognized in any given period.

Our GAAP metrics include the unadjusted impact of amortization and accretion associated with this method. Certain of our non-GAAP metrics exclude the effect of the PAA, which quantifies the component of premium amortization representing the cumulative impact on prior periods, but not the current period, of quarter-over-quarter changes in estimated long-term CPR.

The following table illustrates the impact of the PAA on premium amortization expense for our Residential Investment Securities portfolio for the periods presented:

	For the Three Months Ended	
	March 31, 2018	March 31, 2017
	(dollars in thousands)	
Premium amortization expense	$95,832	$203,634
Less: PAA cost (benefit)	(118,395)	17,870
Premium amortization expense (excluding PAA)	$214,227	$185,764

	For the Three Months Ended	
	March 31, 2018	March 31, 2017
	(per average common share)	
Premium amortization expense	$0.08	$ 0.20
Less: PAA cost (benefit)	(0.11)	0.02
Premium amortization expense (excluding PAA)	$0.19	$ 0.18

Core earnings and core earnings (excluding PAA), core earnings and core earnings (excluding PAA) per average common share and annualized core return on average equity (excluding PAA)

We generate net income by earning a net interest spread on our investment portfolio, which is a function of our interest income from our investment portfolio less financing, hedging and operating costs. Core earnings, which is comprised of interest income plus TBA dollar roll income, less financing and hedging costs and general and administrative expenses, and core earnings (excluding PAA), are used by management and we believe, used by our analysts and investors, to measure progress in achieving our business objectives.

We define "core earnings", a non-GAAP measure, as net income (loss) excluding gains or losses on disposals of investments and termination or maturity of interest rate swaps, unrealized gains or losses on interest rate swaps and investments measured at fair value through earnings, net gains and losses on trading assets, impairment losses, net income (loss) attributable to noncontrolling interest, transaction expenses and certain other non-recurring gains or losses, and inclusive of TBA dollar roll income (a component of Net gains (losses) on trading assets) and realized amortization of MSRs (a component of net unrealized gains (losses) on investments measured at fair value through earnings). Core earnings (excluding PAA) excludes the premium amortization adjustment representing the cumulative impact on prior periods, but not the current period, of quarter-over-quarter changes in estimated long-term prepayment speeds related to our Agency mortgage-backed securities.

We believe these non-GAAP measures provide management and investors with additional details regarding our underlying operating results and investment portfolio trends by (i) making adjustments to account for the disparate reporting of changes in fair value where certain instruments are reflected in GAAP net income (loss) while others are reflected in other comprehensive income (loss), and (ii) by excluding certain unrealized, non-cash or episodic components of GAAP net income (loss) in order to provide additional transparency into the operating performance of our portfolio. Annualized core return on average equity (excluding PAA), which is calculated by dividing core earnings (excluding PAA) over average stockholders' equity, provides investors with additional detail on the core earnings generated by our invested equity capital.

The following table presents a reconciliation of GAAP financial results to non-GAAP core earnings for the periods presented:

49

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

	For the Three Months Ended	
	March 31, 2018	March 31, 2017
	(dollars in thousands, except per share data)	
GAAP net income (loss)	$1,327,704	$440,408
Less:		
Realized (gains) losses on termination or maturity of interest rate swaps	(834)	—
Unrealized (gains) losses on interest rate swaps	(977,285)	(149,184)
Net (gains) losses on disposal of investments	(13,468)	(5,235)
Net (gains) losses on trading assets	47,145	(319)
Net unrealized (gains) losses on financial instruments measured at fair value through earnings	51,593	(23,683)
Transaction expenses (1)	1,519	—
Net (income) loss attributable to noncontrolling interest	96	103
Plus:		
TBA dollar roll income (loss) (2)	88,353	69,968
MSR amortization (3)	(21,156)	(14,030)
Core earnings (4)	503,667	318,028
Less:		
Premium amortization adjustment cost (benefit)	(118,395)	17,870
Core earnings (excluding PAA) (4)	$385,272	$335,898
GAAP net income (loss) per common share	$1.12	$0.41
Core earnings per common share (4)	$0.41	$0.29
Core earnings (excluding PAA) per common share (4)	$0.30	$0.31
Annualized GAAP return (loss) on average equity	36.86%	13.97%
Annualized core return on average equity (excluding PAA) (4)	10.70%	10.66%

(1) Represents costs incurred in connection with a securitization of residential whole loans.

(2) Represents a component of Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss).

(3) Represents the portion of changes in fair value that is attributable to the realization of estimated cash flows on our MSR portfolio and is reported as a component of Net unrealized (gains) losses on investments measured at fair value through earnings in the Consolidated Statements of Comprehensive Income (Loss).

(4) Represents a non-GAAP financial measure. Refer to the "Non-GAAP Financial Measures" section for additional information.

From time to time, we enter into TBA forward contracts as an alternate means of investing in and financing Agency mortgage-backed securities. A TBA contract is an agreement to purchase or sell, for future delivery, an Agency mortgage-backed security with a specified issuer, term and coupon. A TBA dollar roll represents a transaction where TBA contracts with the same terms but different settlement dates are simultaneously bought and sold. The TBA contract settling in the later month typically prices at a discount to the earlier month contract with the difference in price commonly referred to as the "drop". The drop is a reflection of the expected net interest income from an investment in similar Agency mortgage-backed securities, net of an implied financing cost, that would be foregone as a result of settling the contract in the later month rather than in the earlier month. The drop between the current settlement month price and the forward settlement month price occurs because in the TBA dollar roll market, the party providing the financing is the party that would retain all principal and interest payments accrued during the financing period. Accordingly, TBA dollar roll income generally represents the economic equivalent of the net interest income earned on the underlying Agency mortgage-backed security less an implied financing cost.

TBA dollar roll transactions are accounted for under GAAP as a series of derivatives transactions. The fair value of TBA derivatives is based on methods similar to those used to value Agency mortgage-backed securities. We record TBA derivatives at fair value on our Consolidated Statements of Financial Condition and recognize periodic changes in fair value as Net gains (losses) on trading assets in our Consolidated Statements of Comprehensive Income (Loss), which includes both unrealized and realized gains and losses on derivatives (excluding interest rate swaps).

TBA dollar roll income is calculated as the difference in price between two TBA contracts with the same terms but different settlement dates multiplied by the notional amount of the TBA contract. Although accounted for as derivatives, TBA dollar rolls capture the economic equivalent of net interest income, or carry, on the underlying Agency mortgage-backed security (interest income less an implied cost of financing). TBA dollar roll income is reported as a component of Net gains (losses) on trading assets in the Consolidated Statements of Comprehensive Income (Loss).

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

Interest income (excluding PAA), economic interest expense and economic net interest income (excluding PAA)

Interest income (excluding PAA) represents interest income excluding the effect of the premium amortization adjustment, and serves as the basis for deriving average yield on Interest Earning Assets (excluding PAA), net interest spread (excluding PAA) and net interest margin (excluding PAA), which are discussed below. We believe this measure provides management and investors with additional detail to enhance their understanding of our operating results and trends by excluding the component of premium amortization expense representing the cumulative effect of quarter-over-quarter changes in estimated long-term prepayment speeds related to our Agency mortgage-backed securities (other than interest-only securities), which can obscure underlying trends in the performance of the portfolio.

Economic interest expense is comprised of interest expense, as computed in accordance with GAAP, plus interest expense on interest rate swaps. Prior to the three months ended March 31, 2018, economic interest expense included interest expense on interest rate swaps used to hedge cost of funds. Beginning with the three months ended March 31, 2018, as

a result of changes to our hedging portfolio, this metric reflects all interest expense on interest rate swaps, which is reported as Realized gains (losses) on interest rate swaps in the Consolidated Statements of Comprehensive Income (Loss). We use interest rate swaps to manage our exposure to changing interest rates on repurchase agreements by economically hedging cash flows associated with these borrowings. Accordingly, adding the contractual interest payments on interest rate swaps to interest expense, as computed in accordance with GAAP, reflects the total contractual interest expense and thus, provides investors with additional information about the cost of our financing strategy.

Similarly, economic net interest income (excluding PAA), as computed below, provides investors with additional information to enhance their understanding of the net economics of our primary business operations.

The following tables provide GAAP measures of interest expense and net interest income and details with respect to reconciling the aforementioned line items on a non-GAAP basis for each respective period:

Interest Income (excluding PAA)

	GAAP Interest Income	PAA Cost (Benefit)	Interest Income (excluding PAA)
Three Months Ended:	(dollars in thousands)		
March 31, 2018	$879,487	$(118,395)	$ 761,092
March 31, 2017	$587,727	$17,870	$ 605,597

Economic Interest Expense and Economic Net Interest Income (excluding PAA)

	GAAP Interest Expense	Add: Interest Expense on Interest	Economic Interest Expense	GAAP Net Interest Income	Less: Interest Expense on Interest	Economic Net Interest Income	Add: PAA Cost (Benefit)	Economic Net Interest Income

		Rate Swaps (1)			Rate Swaps (1)			(excluding PAA)
Three Months Ended:	(dollars in thousands)							
March 31, 2018	$367,421	$48,160	$415,581	$512,066	$48,160	$463,906	$(118,395)	$345,511
March 31, 2017	$198,425	$88,966	$287,391	$389,302	$88,966	$300,336	$17,870	$318,206

(1) Prior to the three months ended March 31, 2018, economic interest expense included interest expense on interest rate swaps used to hedge cost of funds. Beginning with the three months ended March 31, 2018, as a result of changes to our hedging portfolio, this metric reflects all interest expense on interest rate swaps, which is reported as Realized gains (losses) on interest rate swaps in the Consolidated Statements of Comprehensive Income (Loss).

Experienced and Projected Long-term CPR

Prepayment speeds, as reflected by the Constant Prepayment Rate (“CPR”) and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds and expectations

of prepayment speeds on our Agency mortgage-backed securities portfolio increase, related purchase premium amortization increases, thereby reducing the yield on such assets. The following table presents the weighted average experienced CPR and weighted average projected long-term CPR on our Agency mortgage-backed securities portfolio as of or for the periods presented.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

Three Months Ended	Experienced CPR (1)	Long-term CPR (2)
March 31, 2018	8.9%	9.2%
March 31, 2017	11.5%	10.0%

(1) For the three months ended March 31, 2018 and 2017, respectively.
(2) At March 31, 2018 and 2017, respectively.

Average Yield on Interest Earning Assets (excluding PAA), Net Interest Spread (excluding PAA) and Net Interest Margin (excluding PAA)

Net interest spread (excluding PAA), which is the difference between the average yield on interest earning assets (excluding PAA) and the average cost of interest bearing liabilities, and net interest margin (excluding PAA), which is calculated as sum of interest income (excluding PAA) plus TBA dollar roll income less interest expense and realized

gains (losses) on interest rate swaps divided by the sum of average Interest Earning Assets plus average TBA contract balances, provide management with additional measures of our profitability that management relies upon in monitoring the performance of the business.

Disclosure of these measures, which are presented below, provides investors with additional detail regarding how management evaluates our performance.

Net Interest Spread (excluding PAA)

	Average Interest Earning Assets (1)	Interest Income (excluding PAA) (2)	Average Yield on Interest Earning Assets (excluding PAA) (2)	Average Interest Bearing Liabilities	Economic Interest Expense (2)(3)	Average Cost of Interest Bearing Liabilities (3)	Economic Net Interest Income (excluding PAA) (2)	Net Interest Spread (excluding PAA) (2)
Three Months Ended:	(dollars in thousands)							
March 31, 2018	$101,979,042	$761,092	2.99 %	$87,376,452	$415,581	1.90 %	$345,511	1.09 %
March 31, 2017	$85,664,151	$605,597	2.83 %	$72,422,968	$287,391	1.59 %	$318,206	1.24 %

(1) Does not reflect the unrealized gains/(losses).
(2) Represents a non-GAAP financial measure. Refer to the "Non-GAAP Financial Measures" section for additional information.
(3) Includes GAAP interest expense and interest expense on interest rate swaps. Prior to the three months ended March 31, 2018, this metric included interest expense on interest rate swaps used to hedge cost of funds. Beginning with the three months ended March 31, 2018, as a result of changes to our hedging portfolio, this metric reflects all interest expense on interest rate swaps, which is reported as Realized gains (losses) on interest rate swaps in the Consolidated Statements of Comprehensive Income (Loss).

Net Interest Margin (excluding PAA)

Interest Income	TBA Dollar	Interest Expense	Realized Gains	Subtotal	Average Interest	Average TBA	Subtotal	Net Interest

	(excluding PAA) (1)	Roll Income		(Losses) on Interest Rate Swaps (2)		Earnings Assets	Contract Balances		Margin (excluding PAA) (1)
Three Months Ended:	(dollars in thousands)								
March 31, 2018	$761,092	88,353	(367,421)	(48,160)	$433,864	101,979,042	12,050,341	$114,029,383	1.52 %
March 31, 2017	$605,597	69,968	(198,425)	(104,156)	$372,984	85,664,151	10,655,785	$96,319,936	1.55 %

(1) Represents a non-GAAP financial measure. Refer to the “Non-GAAP Financial Measures” section for additional information.
(2) Consists of interest expense on interest rate swaps.

Economic Interest Expense and Average Cost of Interest Bearing Liabilities

Typically, our largest expense is the cost of Interest Bearing Liabilities and interest expense on interest rate swaps, which is recorded in realized gains (losses) on interest rate swaps

on the Consolidated Statements of Comprehensive Income (Loss). The table below shows our average Interest Bearing Liabilities and average cost of Interest Bearing Liabilities as compared to average one-month and average six-month LIBOR for the periods presented.

53

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

Cost of Funds on Average Interest Bearing Liabilities

	Average Interest Bearing Liabilities	Interest Bearing Liabilities at Period End	Economic Interest Expense (1)	Average Cost of Interest Bearing Liabilities	Average One-Month LIBOR	Average Six-Month LIBOR	Average One-Month LIBOR Relative to Average Six-Month LIBOR	Average Cost of Interest Bearing Liabilities Relative to Average One-Month LIBOR	Average Cost of Interest Bearing Liabilities Relative to Average Six-Month LIBOR
Three Months Ended:	(dollars in thousands)								
March 31, 2018	$87,376,452	$84,750,379	$415,581	1.90 %	1.65 %	2.11 %	(0.46 %)	0.25 %	(0.21)%
March 31, 2017	$72,422,968	$70,085,056	$287,391	1.59 %	0.83 %	1.37 %	(0.54 %)	0.76 %	0.22 %

(1) Economic interest expense includes interest expense on interest rate swaps. Prior to the three months ended March 31, 2018, economic interest expense included interest expense on interest rate swaps used to hedge cost of funds. Beginning with the three months ended March 31, 2018, as a result of changes to our hedging portfolio, this metric reflects all interest expense on interest rate swaps.

Economic interest expense increased by $128.2 million to $415.6 million for the three months ended March 31, 2018 compared to the same period in 2017. The change was primarily due to an increase in average Interest Bearing Liabilities and higher rates on repurchase agreements, partially offset by lower interest expense on interest rate swaps.

We do not manage our portfolio to have a pre-designated amount of borrowings at quarter or year end. Our borrowings at period end are a snapshot of our borrowings as of a date, and this number may differ from average borrowings over the period for a number of reasons. The mortgage-backed securities we own pay principal and interest towards the end of each month and the mortgage-backed securities we purchase are typically settled during the beginning of the month. As a result, depending on the amount of mortgage-backed securities we have committed to purchase, we may retain the principal and interest we receive in the prior month, or we may use it to pay down our borrowings. Moreover, we generally use interest rate swaps, swaptions and other derivative instruments to hedge our portfolio, and as we pledge or receive collateral under these agreements, our borrowings on any given day may be increased or decreased. Our average borrowings during a quarter may differ from period end borrowings as we implement our portfolio management strategies and risk management strategies over changing market conditions by increasing or decreasing leverage. Additionally, these numbers may differ during periods when we conduct equity capital raises, as in certain

instances we may purchase additional assets and increase leverage with the expectation of a successful equity capital raise. Since our average borrowings and period end borrowings can be expected to differ, we believe our average borrowings during a period provide a more accurate representation of our exposure to the risks associated with leverage than our period end borrowings.

At March 31, 2018 and December 31, 2017, the majority of our debt represented repurchase agreements and other secured financing arrangements collateralized by a pledge of our Residential Investment Securities, residential mortgage loans, commercial real estate investments and corporate loans. All of our Residential Investment Securities are currently accepted as collateral for these borrowings. However, we limit our borrowings, and thus our potential asset growth, in order to maintain unused borrowing capacity and increase the liquidity and strength of our balance sheet.

Realized and Unrealized Gains (Losses)

Realized and unrealized gains (losses) is comprised of net gains (losses) on interest rate swaps, net gains (losses) on disposal of investments, net gains (losses) on trading assets and net unrealized gains (losses) on investments measured at fair value through earnings. These components of realized and unrealized gains (losses) for the three months ended March 31, 2018 and 2017 were as follows:

	For the Three Months Ended,	
	March 31, 2018	March 31, 2017
	(dollars in thousands)	
Net gains (losses) on interest rate swaps [1]	$929,959	$ 45,028
Net gains (losses) on disposal of investments	13,468	5,235
Net gains (losses) on trading assets	(47,145)	319
Net unrealized gains (losses) on investments measured at fair value through earnings	(51,593)	23,683
Total	$844,689	$ 74,265

(1) Includes realized gains (losses) on interest rate swaps, realized gains (losses) on termination or maturity of interest rate swaps and unrealized gains (losses) on interest rate swaps.

For the Three Months Ended March 31, 2018 and 2017

Net gains (losses) on interest rate swaps for the three months ended March 31, 2018 was $930.0 million compared to $45.0 million for the same period in 2017. The change was primarily attributable to a $828.1 million increase in unrealized gains on interest rate swaps which was $977.3 million for the three months ended March 31, 2018 compared to $149.2 million for the same period in 2017, reflecting a sharper rise in forward interest rates during the three months ended March 31, 2018 compared to the same period in 2017.

Net gains (losses) on disposal of investments was $13.5 million for the three months ended March 31, 2018 compared with $5.2 million for the same period in 2017. During the three months ended March 31, 2018, we disposed of Residential Investment Securities with a carrying value of $463.4 million for an aggregate net gain of $13.0 million. For the same period in 2017, we disposed of a wholly-owned triple net leased property for a gain of $5.1 million and Residential Investment Securities with a carrying value of $2.1 billion for an aggregate net gain of $1.2 million.

Net gains (losses) on trading assets was ($47.1) million for the three months ended March 31, 2018 compared to $0.3 million for the same period in 2017. The change was primarily due to higher losses on TBA contracts, partially offset by higher net gains on futures contracts and interest rate swaptions for the three months ended March 31, 2018 compared to the same period in 2017.

Net unrealized gains (losses) on investments measured at fair value through earnings was ($51.6) million for the three months ended March 31, 2018 compared to $23.7 million for the same period in 2017, primarily due to unfavorable changes in unrealized gains (losses) on Agency interest-only investments, non-Agency mortgage-backed securities and credit risk transfer securities, partially offset by favorable changes in unrealized gains (losses) on MSRs for the three months ended March 31, 2018 compared to the same period in 2017.

Other Income (Loss)

Other income (loss) includes certain revenues and costs associated with our investments in commercial real estate, including rental income and recoveries, net servicing income on MSRs, operating and transaction costs as well as depreciation and amortization expense. We report in Other income (loss) items whose amounts, either individually or in the aggregate, would not, in the opinion of management, be meaningful to readers of the financial statements. Given the nature of certain components of this line item, balances may fluctuate from period to period.

General and Administrative Expenses

General and administrative ("G&A") expenses consist of compensation expense, the management fee and other expenses. The following table shows our total G&A expenses as compared to average total assets and average equity for the periods presented.

G&A Expenses and Operating Expense Ratios

	Total G&A Expenses	Total G&A Expenses/Average Assets (1)	Total G&A Expenses/Average Equity (1)
For the Three Months Ended:	(dollars in thousands)		
March 31, 2018	$62,510	0.25%	1.74%

March 31, 2017	$53,828	0.25%	1.71%

(1) Includes $1.5 million of transaction costs incurred in connection with a securitization of residential whole loans for the three months ended March 31, 2018. Excluding these transaction costs, G&A expenses as a percentage of average total assets were 0.24% and as a percentage of average equity were 1.69%.

G&A expenses were $62.5 million for the three months ended March 31, 2018, an increase of $8.7 million compared to the same period in 2017. The change was attributable to higher compensation and management fees, reflecting an increase in adjusted stockholders' equity primarily resulting from the equity capital raised during the second half of 2017, and higher other G&A expenses primarily due to costs incurred in connection with a securitization of residential whole loans during the first quarter of 2018.

Unrealized Gains and Losses

With our available-for-sale accounting treatment on our Agency mortgage-backed securities, which represent the largest portion of assets on balance sheet, as well as certain

commercial mortgage-backed securities, unrealized fluctuations in market values of assets do not impact our GAAP or taxable income but rather are reflected on our balance sheet by changing the carrying value of the asset and stockholders' equity under accumulated other comprehensive income (loss). As a result of this fair value accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used amortized cost accounting. As a result, comparisons with companies that use amortized cost accounting for some or all of their balance sheet may not be meaningful.

The table below shows cumulative unrealized gains and losses on our available-for-sale investments reflected in the Consolidated Statements of Financial Condition.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

	March 31, 2018	December 31, 2017
	(dollars in thousands)	
Unrealized gain	$76,217	$157,818
Unrealized loss	(3,076,297)	(1,283,838)
Net unrealized gain (loss)	$(3,000,080)	$(1,126,020)

Unrealized changes in the estimated fair value of available-for-sale investments may have a direct effect on our potential earnings and dividends: positive changes will increase our equity base and allow us to increase our borrowing capacity while negative changes tend to reduce borrowing capacity . A very large negative change in the net fair value of our available-for-sale Residential Investment Securities might impair our liquidity position, requiring us to sell assets with the likely result of realized losses upon sale.

The fair value of these securities being less than amortized cost at March 31, 2018 is solely due to market conditions and not the quality of the assets. Substantially all of the Agency mortgage-backed securities are "AAA" rated or carry an implied "AAA" rating. The investments are not considered to be other-than-temporarily impaired because we currently have the ability and intent to hold the investments to maturity

or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of the investments, and it is not more likely than not that we will be required to sell the investments before recovery of the amortized cost bases, which may be maturity. Also, we are guaranteed payment of the principal and interest amounts of the securities by the respective issuing Agency.

Return on Average Equity

Our annualized return (loss) on average equity was 36.86% and 13.97% for the three months ended March 31, 2018 and 2017, respectively.

The following table shows the components of our annualized return on average equity for the periods presented.

Components of Annualized Return on Average Equity

	Economic Net Interest Income/Average Equity (1)	Realized and Unrealized Gains and Losses/Average Equity (2)	Other Income (Loss)/Average Equity (3)	G&A Expenses/Average Equity	Income Taxes/Average Equity	Return on Average Equity
Three Months Ended:						
March 31, 2018	12.88%	24.80%	0.94%	(1.74%)	(0.02%)	36.86%
March 31, 2017	9.53%	5.18%	1.00%	(1.71%)	(0.03%)	13.97%

(1) Economic net interest income includes interest expense on interest rate swaps. Prior to the three ended March 31, 2018, economic interest expense included interest expense on interest rate swaps used to hedge cost of funds. Beginning with the three months ended March 31, 2018, as a result of changes to our hedging portfolio, this metric reflects all interest expense on interest rate swaps.
(2) Realized and unrealized gains and losses excludes interest expense on interest rate swaps.

(3) Other income (loss) includes investment advisory income, dividend income from affiliate, and other income (loss).

Financial Condition

Total assets were $100.4 billion and $101.8 billion at March 31, 2018 and December 31, 2017, respectively. The change was primarily due to a ($2.0) billion decrease in Residential Investment Securities partially offset by a $200.5

million increase in reverse repurchase agreements and a $141.5 million increase in corporate debt. Our portfolio composition, net equity allocation and debt-to-net equity ratio by asset class was as follows at March 31, 2018:

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

	Residential				Commercial			
	Agency MBS and MSRs	TBAs [1]	CRTs	Non-Agency MBS and Residential Mortgage Loans	CRE Debt & Preferred Equity Investments	Investments in CRE	Corporate Debt	Total [2]
	(dollars in thousands)							
Assets:								
Fair Value/Carrying Value	$89,175,475	$9,132,631	$628,942	$2,602,028	$4,041,618	$480,063	$1,152,745	$98,080,
Debt:								
Repurchase agreements	76,963,498	8,954,000	326,985	309,599	415,349	—	—	78,015,4
Other secured financing	2,711,228	—	—	735,004	158,651	—	225,192	3,830,07
Securitized debt	—	—	—	407,463	2,497,410	—	—	2,904,87
Net forward purchases	46,201	—	—	—	—	—	—	46,201
Mortgages payable	—	—	—	—	—	309,794	—	309,794
Net Equity Allocated	$9,454,548	$178,631	$301,957	$1,149,962	$970,208	$170,269	$927,553	12,974,4
Net Equity Allocated (%)	74 %	1 %	2 %	9 %	7 %	1 %	7 %	100
Debt/Net Equity Ratio	8.4:1	50.1:1	1.1:1	1.3:1	3.2:1	1.8:1	0.2:1	6.1:1

(1) Fair value/carrying value represents implied market value and repurchase agreements represent the notional value.
(2) Excludes the TBA asset, debt and equity balances.
(3) Net Equity Allocated, as disclosed in the above table, excludes non-portfolio related activity and may differ from stockholders' equity per the Consolidated Statements of Financial Condition.
(4) Represents the debt/net equity ratio as determined using amounts on the Consolidated Statements of Financial Condition.

Residential Investment Securities

Substantially all of our Agency mortgage-backed securities at March 31, 2018 and December 31, 2017 were backed by single-family residential mortgage loans and were secured with a first lien position on the underlying single-family properties. Our mortgage-backed securities were largely Freddie Mac, Fannie Mae or Ginnie Mae pass through certificates or CMOs, which carry an actual or implied "AAA" rating. We carry all of our Agency mortgage-backed securities at fair value on the Consolidated Statements of Financial Condition.

We accrete discount balances as an increase to interest income over the expected life of the related Interest Earning Assets and we amortize premium balances as a decrease to interest income over the expected life of the related Interest Earning Assets. At March 31, 2018 and December 31, 2017 we had on our Consolidated Statements of

Financial Condition a total of $143.1 million and $148.3 million, respectively, of unamortized discount (which is the difference between the remaining principal value and current amortized cost of our Residential Investment Securities acquired at a price below principal value) and a total of $6.2 billion of unamortized premium (which is the difference between the remaining principal value and the current amortized cost of our Residential Investment Securities acquired at a price above principal value).

The weighted average experienced prepayment speed on our Agency mortgage-backed securities portfolio for the three months ended March 31, 2018 and 2017 was 8.9% and 11.5%, respectively. The weighted average projected long-term prepayment speed on our Agency mortgage-backed securities portfolio as of March 31, 2018 and 2017 was 9.2% and 10.0%, respectively.

Given our current portfolio composition, if mortgage principal prepayment rates were to increase over the life of our mortgage-backed securities, all other factors being equal, our net interest income would decrease during the life of these mortgage-backed securities as we would be required to amortize our net premium balance into income over a shorter time period. Similarly, if mortgage principal prepayment rates were to decrease over the life of our mortgage-backed securities, all other factors being equal, our net interest income would increase during the life of these mortgage-backed securities as we would amortize our net premium balance over a longer time period.

The following table summarizes certain characteristics of our Residential Investment Securities (excluding interest-only mortgage-backed securities) and interest-only mortgage-backed securities at the dates presented.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

	March 31, 2018	December 31, 2017
	(dollars in thousands)	
Residential Investment Securities: (1)		
Principal Amount	$87,381,276	$87,518,155
Net Premium	4,752,799	4,682,299
Amortized Cost	92,134,075	92,200,454
Amortized Cost/Principal Amount	105.44 %	105.35 %
Carrying Value	89,236,193	91,197,901
Carrying Value / Principal Amount	102.12 %	104.20 %
Weighted Average Coupon Rate	3.70 %	3.69 %
Weighted Average Yield	2.87 %	2.79 %
Adjustable-Rate Residential Investment Securities: (1)		
Principal Amount	$7,571,513	$8,002,252
Weighted Average Coupon Rate	3.12 %	3.05 %
Weighted Average Yield	2.75 %	2.52 %
Weighted Average Term to Next Adjustment	23 Months	24 Months
Weighted Average Lifetime Cap (2)	8.07 %	8.12 %
Principal Amount at Period End as % of Total Residential Investment Securities	8.66 %	9.14 %
Fixed-Rate Residential Investment Securities: (1)		
Principal Amount	$79,809,763	$79,515,903
Weighted Average Coupon Rate	3.76 %	3.75 %
Weighted Average Yield	2.88 %	2.82 %
Principal Amount at Period End as % of Total Residential Investment Securities	91.34 %	90.86 %
Interest-Only Residential Investment Securities:		
Notional Amount	$7,595,757	$7,793,767
Net Premium	1,310,810	1,342,048
Amortized Cost	1,310,810	1,342,048
Amortized Cost/Notional Amount	17.26 %	17.22 %
Carrying Value	1,038,189	1,102,920
Carrying Value/Notional Amount	13.67 %	14.15 %
Weighted Average Coupon Rate	3.47 %	3.61 %
Weighted Average Yield	4.45 %	4.17 %

(1) Excludes interest-only mortgage-backed securities.
(2) Excludes non-Agency mortgage-backed securities and CRT securities as this attribute is not applicable to these asset classes.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

The following tables summarize certain characteristics of our Residential Credit portfolio at March 31, 2018.

		Payment Structure		Investment Characteristics			
Product	Estimated Fair Value	Senior	Subordinate	Coupon	Credit Enhancement	60+ Delinquencies	3M VPR (1)
(dollars in thousands)							
Agency Credit Risk Transfer	$597,336	$—	$597,336	5.33%	1.17 %	0.42 %	7.70 %
Private Label Credit Risk Transfer	31,606	—	31,606	7.68%	4.96 %	2.55 %	11.68%
Alt-A	180,039	112,359	67,680	4.49%	10.43 %	12.33 %	9.66 %
Prime	214,828	50,039	164,789	4.53%	3.76 %	10.11 %	12.03%
Subprime	492,506	206,799	285,707	2.97%	11.87 %	20.14 %	5.33 %
Re-Performing Loan Securitizations	31,288	31,288	—	4.09%	43.11 %	33.70 %	6.57 %
Non-Performing Loan Securitizations	8,284	4,833	3,451	4.68%	64.00 %	69.71 %	6.41 %
Prime Jumbo (>=2010 Vintage)	121,200	95,150	26,050	3.59%	14.44 %	0.01 %	11.26%
Prime Jumbo (>=2010 Vintage) Interest-Only	18,198	18,198	—	0.46%	— %	0.05 %	15.64%
Total/Weighted Average	$1,695,285	$518,666	$1,176,619	4.54%	8.04 %	10.15 %	16.81%

(1) Represents the 3 month voluntary prepayment rate ("VPR").

Market Value By Sector and Bond Coupon

Product	ARM	Fixed	Floater	Interest-Only	Estimated Fair Value
(dollars in thousands)					
Agency Credit Risk Transfer	$—	$—	$597,336	$ —	$597,336
Private Label Credit Risk Transfer	—	—	31,606	—	31,606
Alt-A	49,829	103,557	26,653	—	180,039
Prime	116,989	97,839	—	—	214,828
Subprime	—	93,112	399,394	—	492,506
Re-Performing Loan Securitizations	—	31,288	—	—	31,288
Non-Performing Loan Securitizations	—	8,284	—	—	8,284
Prime Jumbo (>=2010 Vintage)	—	121,200	—	—	121,200
Prime Jumbo (>=2010 Vintage) Interest-Only	—	—	—	18,198	18,198
Total	$166,818	$455,280	$1,054,989	$ 18,198	$1,695,285

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

Contractual Obligations

The following table summarizes the effect on our liquidity and cash flows from contractual obligations at March 31, 2018. The table does not include the effect of net interest rate payments on our interest rate swap agreements. The net swap

payments will fluctuate based on monthly changes in the receive rate. At March 31, 2018, the interest rate swaps had a net fair value of ($358.7) million.

	Within One Year	One to Three Years	Three to Five Years	More than Five Years	Total
	(dollars in thousands)				
Repurchase agreements	$78,015,431	$—	$—	$—	$78,015,431
Interest expense on repurchase agreements [1]	317,461	—	—	—	317,461
Other secured financing	3,607	3,601,276	225,192	—	3,830,075
Interest expense on other secured financing [1]	84,253	148,693	6,339	—	239,285
Securitized debt of consolidated VIEs (principal)	—	—	1,884,873	988,186	2,873,059
Interest expense on securitized debt of consolidated VIEs	68,671	137,343	124,643	339,357	670,014
Mortgages payable (principal)	—	23,375	—	289,125	312,500
Interest expense on mortgages payable	13,263	25,051	24,746	29,844	92,904
Long-term operating lease obligations	3,267	7,266	7,723	9,976	28,232
Total	$78,505,953	$3,943,004	$2,273,516	$1,656,488	$86,378,961

(1) Interest expense on repurchase agreements and other secured financing calculated based on rates at March 31, 2018.

In the coming periods, we expect to continue to finance our Residential Investment Securities in a manner that is largely consistent with our current operations via repurchase agreements. We may use FHLB Des Moines advances, securitization structures, mortgages payable or other term financing structures to finance certain of our assets. During the three months ended March 31, 2018, we received $2.7 billion from principal repayments and $463.2 million in cash from disposal of Residential Investment Securities, respectively. During the three months ended March 31, 2017, we received $3.0 billion from principal repayments and $1.8 billion in cash from disposal of Residential Investment Securities.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships which would have been established for the sole purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

We have limited future funding commitments related to certain of our unconsolidated joint ventures. In addition, the Company has provided customary non-recourse carve-out and environmental guarantees (or underlying indemnities with respect thereto) with respect to mortgage loans held by subsidiaries of these unconsolidated joint ventures. We believe that the likelihood of making any payments under these guarantees is remote, and have not accrued a related liability at March 31, 2018.

Capital Management

Maintaining a strong balance sheet that can support the business even in times of economic stress and market volatility is of critical importance to our business strategy. A strong and robust capital position is essential to executing our investment strategy. Our capital strategy is predicated on a strong capital position, which enables us to execute our investment strategy regardless of the market environment.

Our Internal Capital Adequacy Assessment Program ("ICAAP") framework supports capital measurement, and is integrated within the overall risk governance framework. The ICAAP framework is designed to align capital measurement with our risk appetite.

Our capital policy defines the parameters and principles supporting a comprehensive capital management practice, including processes that effectively identify, measure and monitor risks impacting capital adequacy. Our capital assessment process considers the precision in risk measures as well as the volatility of exposures and the relative activities producing risk. Parameters used in modeling economic capital must align with our risk appetite.

The major risks impacting capital are liquidity, investment/market, credit, counterparty, operational and compliance, regulatory and legal risks. For further discussion of the risks we are subject to, please see Part I, Item 1A. "Risk Factors" in our most recent Annual Report on Form 10-K and Item 1A. "Risk Factors" in quarterly reports on Form 10-Q.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

Capital requirements are based on maintaining levels above approved limits, ensuring the quality of our capital appropriately reflects our asset mix, market and funding structure. As such we use a complement of capital metrics and related threshold levels to measure and analyze our capital from a magnitude and composition perspective. Our policy is to maintain an appropriate amount of available financial resources over the aggregate economic capital requirements.

Available Financial Resources is the actual capital held to protect against the unexpected losses measured in our capital management process and may include:

- Common and preferred equity
- Other forms of equity-like capital
- Surplus credit reserves over expected losses
- Other loss absorption instruments

In the event we fall short of our internal limits, we will consider appropriate actions which may include asset sales, changes in asset mix, reductions in asset purchases or originations, issuance of capital or other capital enhancing or risk reduction strategies.
Stockholders' Equity

The following table provides a summary of total stockholders' equity at March 31, 2018 and December 31, 2017:

	March 31, 2018	December 31, 2017
Stockholders' Equity:	(dollars in thousands)	
7.625% Series C Cumulative Redeemable Preferred Stock	$169,466	$290,514
7.50% Series D Cumulative Redeemable Preferred Stock	445,457	445,457
7.625% Series E Cumulative Redeemable Preferred Stock	—	287,500
6.95% Series F Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock	696,910	696,910
6.50% Series G Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock	411,335	—
Common stock	11,597	11,596
Additional paid-in capital	17,218,191	17,221,265
Accumulated other comprehensive income (loss)	(3,000,080)	(1,126,020)
Accumulated deficit	(2,015,612)	(2,961,749)
Total stockholders' equity	$13,937,264	$14,865,473

Common and Preferred Stock

The following table provides a summary of options activity for the periods presented:

	Options Exercised	Aggregate Exercise Price	Shares Issued Through Direct Purchase	Amount Raised from Direct Purchase and Dividend Reinvestment Program
For the Three Months Ended:	(dollars in thousands)			

March 31, 2018	—$	—70,000	$ 746
March 31, 2017	—$	—56,000	$ 596

Leverage and Capital

We believe that it is prudent to maintain conservative debt-to-equity and economic leverage ratios as there continues to be volatility in the mortgage and credit markets. Our capital policy governs our capital and leverage position including setting limits. Based on the guidelines, we generally expect to maintain an economic leverage ratio of less than 10:1. Our actual economic leverage ratio varies from time to time based upon various factors, including our Manager's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity, the availability of credit, over-collateralization levels required by lenders when we pledge assets to secure borrowings and our assessment of domestic and international market conditions.

Our debt-to-equity ratio at March 31, 2018 and December 31, 2017 was 6.1:1 and 5.7:1, respectively. Our economic leverage ratio, which is computed as the sum of Recourse Debt, TBA derivative notional outstanding and net forward purchases of investments divided by total equity, at March 31, 2018 and December 31, 2017 was 6.5:1 and 6.6:1, respectively. Our capital ratio, which represents our ratio of stockholders' equity to total assets (inclusive of total market value of TBA derivatives and exclusive of securitized debt of consolidated VIEs), was 13.1% and 12.9% at March 31, 2018 and December 31, 2017, respectively.

Risk Management

We are subject to a variety of risks in the ordinary conduct of our business. The effective management of these risks is of critical importance to the overall success of Annaly. The objective of our risk management framework is to identify, measure, monitor and manage these risks.

Our risk management framework is intended to facilitate a holistic, enterprise wide view of risk. We have built a strong and collaborative risk management culture throughout Annaly focused on awareness which ensures the key risks are understood and managed appropriately. Each employee of our Manager is accountable for monitoring and managing risk within their area of responsibility.

Risk Appetite

We maintain a firm-wide risk appetite statement which defines the types and levels of risk we are willing to take in order to achieve our business objectives, and reflects our risk management philosophy. We engage in risk activities based on our core expertise that aim to enhance value for our stockholders. Our activities focus on capital preservation and income generation through proactive portfolio management, supported by a conservative liquidity and leverage posture.

The risk appetite statement asserts the following key risk parameters to guide our investment management activities:

Risk Parameter	Description
Portfolio Composition	We will maintain a portfolio comprised of target assets approved by our Board and in accordance with our capital allocation policy.
Leverage	We will operate at an economic leverage ratio no greater than 10:1.
Liquidity Risk	We will seek to maintain an unencumbered asset portfolio sufficient to meet our liquidity needs under adverse market conditions.
Interest Rate Risk	We will seek to manage interest rate risk to protect the portfolio from adverse rate movements utilizing derivative instruments targeting both income and capital preservation.
Credit Risk	We will seek to manage credit risk by making investments which conform within our specific investment policy parameters and optimize risk-adjusted returns.
Capital Preservation	We will seek to protect our capital base through disciplined risk management practices.
Compliance	We will comply with regulatory requirements needed to maintain our REIT status and our exemption from registration under the Investment Company Act.

Governance

Risk management begins with our Board, through the review and oversight of the risk management framework, and executive management, through the ongoing formulation of risk management practices and related execution in managing risk. The Board exercises its oversight of risk management primarily through the Board Risk Committee ("BRC") and Board Audit Committee ("BAC"). The BRC is responsible for oversight of our risk governance structure, risk management and risk assessment guidelines and policies and our risk appetite. The BAC is responsible for oversight of the quality and integrity of our accounting, internal controls and financial reporting practices, including independent auditor selection, evaluation and review, and oversight of the internal audit function.

Risk assessment and risk management are the responsibility of our management. A series of management committees have oversight or decision-making responsibilities for risk management activities. Membership of these committees is reviewed regularly to ensure the appropriate personnel are engaged in the risk management process. Four primary management committees have been established to provide a comprehensive framework for risk management. The management committees responsible for our risk

management include the Enterprise Risk Committee (“ERC”), Asset and Liability Committee (“ALCO”), Investment Committee and the Financial Reporting and Disclosure Committee (“FRDC”). Each of these committees reports to our management Operating Committee which is responsible for oversight and management of our operations, including oversight and approval authority over all aspects of our enterprise risk management.

Audit Services is an independent function with reporting lines to the BAC. Audit Services is responsible for performing our internal audit activities, which includes independently assessing and validating key controls within the risk management framework.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

Description of Risks

We are subject to a variety of risks due to the business we operate. Risk categories are an important component of a robust enterprise wide risk management framework.

We have identified the following primary categories that we utilize to identify, assess, measure and monitor risk.

Risk	Description
Capital, Liquidity and Funding Risk	Risk to earnings, capital or business arising from our inability to meet our obligations when they come due without incurring unacceptable losses because of inability to liquidate assets or obtain adequate funding.
Investment/Market Risk	Risk to earnings, capital or business resulting in the decline in value of our assets or an increase in the costs of financing caused by changes in market variables, such as interest rates, which affect the values of investment securities and other investment instruments.
Credit Risk	Risk to earnings, capital or business resulting from an obligor's failure to meet the terms of any contract or otherwise failure to perform as agreed. This risk is present in lending and investing activities.
Counterparty Risk	Risk to earnings, capital or business resulting from a counterparty's failure to meet the terms of any contract or otherwise failure to perform as agreed. This risk is present in funding, hedging and investing activities.
Operational Risk	Risk to earnings, capital, reputation or business arising from inadequate or failed internal processes or systems, human factors or external events. Model risk is included in operational risk.
Compliance, Regulatory and Legal Risk	Risk to earnings, capital, reputation or conduct of business arising from violations of, or nonconformance with internal and external applicable rules and regulations, losses resulting from lawsuits or adverse judgments, or from changes in the regulatory environment that may impact our business model.

Capital, Liquidity and Funding Risk Management

Our capital, liquidity and funding risk management strategy is designed to ensure the availability of sufficient resources to support our business and meet our financial obligations under both normal and adverse market and business

environments. Our capital, liquidity and funding risk management practices consist of the following primary elements:

Element	Description
Funding	Availability of diverse and stable sources of funds.
Excess Liquidity	Excess liquidity primarily in the form of unencumbered assets.
Maturity Profile	Diversity and tenor of liabilities and modest use of leverage.
Stress Testing	Scenario modeling to measure the resiliency of our liquidity position.
Liquidity Management Policies	Comprehensive policies including monitoring, risk limits and an escalation protocol.

Funding

Our primary financing sources are repurchase agreements provided through counterparty arrangements and through RCap, other secured financing including funding from the Federal Home Loan Bank ("FHLB"), securitized debt, mortgages, credit facilities, note sales and various forms of equity. We maintain excess liquidity by holding unencumbered liquid assets that could be either sold or used to collateralize additional borrowings.

We conservatively manage our repurchase agreement funding position through a variety of methods including diversity, breadth and depth of counterparties and maintaining a staggered maturity profile.

Additionally, our wholly-owned subsidiary, RCap, provides direct access to third party funding as a FINRA member broker-dealer. RCap borrows funds through the General Collateral Finance Repo service offered by the Fixed Income Clearing Corporation ("FICC"), with FICC acting as the central counterparty. RCap may also borrow funds through other repurchase agreements.

To reduce our liquidity risk we maintain a laddered approach to our repurchase agreements. At March 31, 2018, the weighted average days to maturity was 72 days.

Our repurchase agreements generally provide that in the event of a margin call we must provide additional securities or cash on the same business day that a margin call is made. Should prepayment speeds on the mortgages underlying our Agency and Residential mortgage-backed securities and/or market interest rates or other factors move suddenly and cause declines in the market value of assets posted as collateral, resulting margin calls may cause an adverse change in our liquidity position.

We maintain access to FHLB funding through our captive insurance subsidiary Truman Insurance Company LLC ("Truman"). We finance eligible Agency, residential credit and commercial investments through the FHLB. A rule from the Federal Housing Finance Agency ("FHFA") requires captive insurance companies to terminate their FHLB membership, however, given the length of its membership, Truman was granted a five year sunset provision whereby its membership will expire in February 2021. We believe our business objectives align well with the mission of the FHLB System. While there can be no assurances that such steps will be taken, we believe it would be appropriate for there to be legislative or other action to permit Truman and similar captive insurance subsidiaries to retain their membership status beyond the current sunset period.

We utilize diverse funding sources to finance our commercial investments. Aside from FHLB funding, we may utilize credit facilities, securitization funding and, in the case of investments in commercial real estate, mortgage financing and note sales.

At March 31, 2018, we had total financial assets and cash pledged against existing liabilities of $91.2 billion. The weighted average haircut was approximately 4% on repurchase agreements. The quality and character of the Residential Investment Securities and commercial real estate investments that we pledge as collateral under the repurchase agreements and interest rate swaps did not materially change at March 31, 2018 compared to December 31, 2017, and our counterparties did not materially alter any requirements, including required haircuts, related to the collateral we pledge under repurchase agreements and interest rate swaps during the three months ended March 31, 2018.

The following table presents our quarterly average and quarter-end repurchase agreement and reverse repurchase agreement balances outstanding for the periods presented:

	Repurchase Agreements		Reverse Repurchase Agreements	
	Average Daily Amount Outstanding	Ending Amount Outstanding	Average Daily Amount Outstanding	Ending Amount Outstanding
Three Months Ended:	(dollars in thousands)			
March 31, 2018	$80,770,663	$78,015,431	$2,064,862	$ 200,459
December 31, 2017	78,755,896	77,696,343	1,295,652	—
September 30, 2017	69,314,576	69,430,268	994,565	—
June 30, 2017	63,191,827	62,497,400	474,176	—
March 31, 2017	64,961,511	62,719,087	1,738,333	—
December 31, 2016	64,484,326	65,215,810	1,064,130	—
September 30, 2016	63,231,246	61,784,121	1,494,022	—
June 30, 2016	54,647,175	53,868,385	1,159,341	—
March 31, 2016	55,753,041	54,448,141	1,294,505	—

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

The following table provides information on our repurchase agreements and other secured financing by maturity date at March 31, 2018. The weighted average remaining maturity on our repurchase agreements and other secured financing was 116 days at March 31, 2018:

March 31, 2018

	Principal Balance	Weighted Average Rate	% of Total
	(dollars in thousands)		
1 day	$—	— %	— %
2 to 29 days	39,527,178	1.76 %	48.3 %
30 to 59 days	8,619,507	1.67 %	10.5 %
60 to 89 days	10,243,046	1.83 %	12.5 %
90 to 119 days	5,381,838	1.64 %	6.6 %
Over 120 days (1)	18,073,937	2.19 %	22.1 %
Total	$81,845,506	1.84 %	100.0%

(1) Approximately 5% of the total repurchase agreements and other secured financing had a remaining maturity over 1 year.

The table below presents our outstanding debt balances and associated weighted average rates and days to maturity at March 31, 2018:

		Weighted Average Rate		
	Principal Balance	At Period End	For the Quarter	Weighted Average Days to Maturity (1)
	(dollars in thousands)			
Repurchase agreements	$78,015,431	1.83%	1.64 %	72
Other secured financing (2)	3,830,075	2.18%	2.14 %	1,022
Securitized debt of consolidated VIEs (3)	2,873,059	2.39%	2.24 %	3,348
Mortgages payable (3)	312,500	4.24%	4.32 %	2,498
Total indebtedness	$85,031,065			

(1) Determined based on estimated weighted-average lives of the underlying debt instruments.
(2) Includes advances from the Federal Home Loan Bank of Des Moines of $3.6 billion and financing under credit facilities.
(3) Non-recourse to Annaly.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

Excess Liquidity

Our primary source of liquidity is the availability of unencumbered assets which may be provided as collateral to support additional funding needs. We target minimum thresholds of available, unencumbered assets to maintain excess liquidity. The following table illustrates our asset portfolio available to support potential collateral obligations and funding needs.

Assets are considered encumbered if pledged as collateral against an existing liability, and therefore no longer available to support additional funding. An asset is considered unencumbered if it has not been pledged or securitized. The following table also provides the carrying amount of our encumbered and unencumbered financial assets at March 31, 2018:

	Encumbered Assets	Unencumbered Assets	Total
	(dollars in thousands)		
Financial Assets:			
Cash and cash equivalents	$884,667	$ 99,608	$984,275
Investments, at carrying value: (1)			
Agency mortgage-backed securities	83,893,493	4,560,031	88,453,524
Credit risk transfer securities	411,780	214,111	625,891
Non-Agency mortgage-backed securities	499,271	567,072	1,066,343
Residential mortgage loans	1,376,883	158,802	1,535,685
MSRs	5,153	591,225	596,378
Commercial real estate debt investments	2,900,098	60,225	2,960,323
Commercial real estate debt and preferred equity, held for investment	529,324	551,971	1,081,295
Corporate debt	666,682	486,063	1,152,745
Total financial assets	$91,167,351	$ 7,289,108	$98,456,459

(1) The amounts reflected in the table above are on a settlement date basis and may differ from the total positions reported on the Consolidated Statements of Financial Condition.

We maintain liquid assets in order to satisfy our current and future obligations in normal and stressed operating environments. These are held as the primary means of liquidity risk mitigation. The composition of our liquid assets is also considered and is subject to certain parameters. The composition is monitored for concentration risk and asset type. We believe the assets we consider liquid can be readily converted into cash, through liquidation or by being used as

collateral in financing arrangements (including as additional collateral to support existing financial arrangements). Our balance sheet also generates liquidity on an on-going basis through mortgage principal and interest repayments and net earnings held prior to payment of dividends. The following table presents our liquid assets as a percentage of total assets at March 31, 2018.

Liquid Assets	Carrying Value (1)
	(dollars in thousands)
Cash and cash equivalents	$984,275
Residential Investment Securities (2)	90,145,758
Residential mortgage loans (3)	975,491

Commercial real estate debt investments [4]	264,810
Commercial real estate debt and preferred equity, held for investment	723,997
Corporate debt	763,023
Total liquid assets	$93,857,354
Percentage of liquid assets to carrying amount of encumbered and unencumbered financial assets [3][4]	98.59 %

(1) Carrying value approximates the market value of assets. The assets listed in this table include $88.5 billion of assets that have been pledged as collateral against existing liabilities at March 31, 2018. Please refer to the Encumbered and Unencumbered Assets table for related information.

(2) The amounts reflected in the table above are on a settlement date basis and may differ from the total positions reported on the Consolidated Statements of Financial Condition.

(3) Excludes securitized residential mortgage loans transferred or pledged to consolidated VIEs carried at fair value of $560.2 million.

(4) Excludes senior securitized commercial mortgage loans of consolidated VIEs carried at fair value of $2.7 billion.

Maturity Profile

We consider the profile of our assets, liabilities and derivatives when managing both liquidity risk as well as investment/market risk employing a measurement of both the maturity gap and interest rate gap.

We determine the amount of liquid assets that are required to be held by monitoring several liquidity metrics. We utilize several modeling techniques to analyze our current and potential obligations including the expected cash flows from our assets, liabilities and derivatives. The following table illustrates the expected final maturities and cash flows of our assets, liabilities and derivatives. The table is based on a static portfolio and assumes no reinvestment of asset cash flows and no future liabilities are entered into. In assessing the maturity of our assets, liabilities and off balance sheet obligations, we use the stated maturities, or our prepayment expectations for assets and liabilities that exhibit prepayment characteristics. Cash and cash equivalents are included in the 'Less than 3 Months' maturity bucket, as they are typically held for a short period of time.

With respect to each maturity bucket, our maturity gap is considered negative when the amount of maturing liabilities exceeds the amount of maturing assets. A negative gap increases our liquidity risk as we must enter into future liabilities.

Our interest rate sensitivity gap is the difference between Interest Earning Assets and Interest Bearing Liabilities

maturing or re-pricing within a given time period. Unlike the calculation of maturity gap, interest rate sensitivity gap includes the effect of our interest rate swaps. A gap is considered positive when the amount of interest-rate sensitive assets exceeds the amount of interest-rate sensitive liabilities. A gap is considered negative when the amount of interest-rate sensitive liabilities exceeds interest-rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market rates or conditions, changes in interest rates may affect net interest income positively or negatively even if assets and liabilities were perfectly matched in each maturity category. The amount of assets and liabilities utilized to compute our interest rate sensitivity gap was determined in accordance with the contractual terms of the assets and liabilities, except that adjustable-rate loans and securities are included in the period in which their interest rates are first scheduled to adjust and not in the period in which they mature. The effects of interest rate swaps, which effectively lock in our financing costs for a longer term, are also reflected in our interest rate sensitivity gap. The interest rate sensitivity of our assets and liabilities in the following table at March 31, 2018 could vary substantially based on actual prepayment experience.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

	Less than 3 Months	3-12 Months	More than 1 Year to 3 Years	3 Years and Over	Total
Financial Assets:	(dollars in thousands)				
Cash and cash equivalents	$984,275	$—	$—	$—	$984,275
Agency mortgage-backed securities (principal)	—	—	1,665,951	84,031,652	85,697,603
Credit risk transfer securities (principal)	—	—	10,006	569,071	579,077
Non-Agency mortgage-backed securities (principal)	—	9,748	119,552	975,296	1,104,596
Residential mortgage loans (principal)	—	—	—	1,527,171	1,527,171
Commercial real estate debt investments (principal)	—	—	—	2,941,236	2,941,236
Commercial real estate debt and preferred equity (principal)	101,551	365,783	492,996	125,103	1,085,433
Corporate debt (principal)	—	—	50,078	1,114,376	1,164,454
Reverse repurchase agreements	200,459	—	—	—	200,459
Total financial assets - maturity	1,286,285	375,531	2,338,583	91,283,905	95,284,304
Effect of utilizing reset dates (1)	6,926,553	2,232,539	771,441	(9,930,533)	
Total financial assets - interest rate sensitive	$8,212,838	$2,608,070	$3,110,024	$81,353,372	$95,284,304
Financial Liabilities:					
Repurchase agreements	$58,753,814	$19,261,617	$—	$—	$78,015,431
Other secured financing	—	3,607	3,601,276	225,192	3,830,075
Securitized debt of consolidated VIE (principal)	—	—	—	2,873,059	2,873,059
Total financial liabilities - maturity	58,753,814	19,265,224	3,601,276	3,098,251	84,718,565
Effect of utilizing reset dates (1)(2)	(57,104,744)	13,337,921	19,283,674	24,483,149	
Total financial liabilities - interest rate sensitive	$1,649,070	$32,603,145	$22,884,950	$27,581,400	$84,718,565
Maturity gap	$(57,467,529)	$(18,889,693)	$(1,262,693)	$88,185,654	$10,565,739
Cumulative maturity gap	$(57,467,529)	$(76,357,222)	$(77,619,915)	$10,565,739	
Interest rate sensitivity gap	$6,563,768	$(29,995,075)	$(19,774,926)	$53,771,972	$10,565,739
Cumulative rate sensitivity gap	$6,563,768	$(23,431,307)	$(43,206,233)	$10,565,739	

(1) Maturity gap utilizes stated maturities, or prepayment expectations for assets that exhibit prepayment characteristics, while interest rate sensitivity gap utilizes reset dates, if applicable.
(2) Includes effect of interest rate swaps.

The methodologies we employ for evaluating interest rate risk include an analysis of our interest rate "gap," measurement of the duration and convexity of our portfolio and sensitivities to interest rates and spreads.

Stress Testing

We utilize liquidity stress testing to ensure we have sufficient liquidity under a variety of scenarios and stresses. These stress tests assist with the management of our pool of liquid assets and influence our current and future funding plans. Our stress tests are modeled over both short term and longer time horizons. The stresses applied include market-wide and firm-specific stresses.

Liquidity Management Policies

We utilize a comprehensive liquidity policy structure to inform our liquidity risk management practices including monitoring and measurement, along with well-defined key limits. Both quantitative and qualitative targets are utilized

to measure the ongoing stability and condition of the liquidity position, and include the level and composition of unencumbered assets, as well as both short-term and long-term sustainability of the funding composition under stress conditions.

We also monitor early warning metrics designed to measure the quality and depth of liquidity sources based upon both company-specific and market conditions. The metrics assist in assessing our liquidity conditions and are integrated into our escalation protocol, with various liquidity ratings influencing management actions with respect to contingency planning and potential related actions.

Investment/Market Risk Management

One of the primary risks we are subject to is investment/market risk. Changes in the level of interest rates can affect our net interest income, which is the difference between the income we earn on our Interest Earning Assets and the interest expense incurred from Interest Bearing Liabilities and

derivatives. Changes in the level of interest rates and spreads can also affect the value of our securities and potential realization of gains or losses from the sale of these assets. We may utilize a variety of financial instruments, including interest rate swaps, swaptions, options, futures and other hedges, in order to limit the adverse effects of interest rates on our results. In the case of interest rate swaps, we may use
market agreed coupon (“MAC”) interest rate swaps in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of market nature of such interest rate swap. MAC interest rate swaps offer increased liquidity and more efficient portfolio administration through compression which is the process of reducing the number of unique interest rate swap contracts and replacing them with fewer contracts containing market defined terms. Our portfolio and the value of our portfolio, including derivatives, may be adversely affected as a result of changing interest rates and spreads.

We simulate a wide variety of interest rate scenarios in evaluating our risk. Scenarios are run to capture our sensitivity to changes in interest rates, spreads and the shape of the yield curve. We also consider the assumptions affecting our analysis such as those related to prepayments. In addition

to predefined interest rate scenarios, we utilize Value-at-Risk measures to estimate potential losses in the portfolio over various time horizons utilizing various confidence levels. The following tables estimate the potential changes in economic net interest income over a twelve month period and the immediate effect on our portfolio market value (inclusive of derivative instruments), should interest rates instantaneously increase or decrease by 25, 50 or 75 basis points, and the effect of portfolio market value if mortgage option-adjusted spreads instantaneously increase or decrease by 5, 15 or 25 basis points (assuming shocks are parallel and instantaneous). All changes to income and portfolio market value are measured as percentage changes from the projected net interest income and portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates at March 31, 2018. The net interest income simulations incorporate the interest expense effect of rate resets on liabilities and derivatives as well as the amortization expense and reinvestment of principal based on the prepayments on our securities, which varies based on the level of rates. The results assume no management actions in response to the rate or spread changes. The following table presents estimates at March 31, 2018. Actual results could differ materially from these estimates.

Change in Interest Rate (1)	Projected Percentage Change in Economic Net Interest Income (2)	Estimated Percentage Change in Portfolio Value (3)	Estimated Change as a % on NAV (3)(4)
-75 Basis Points	(13.3%)	0.3%	2.5%
-50 Basis Points	(6.9%)	0.3%	2.5%
-25 Basis Points	(2.2%)	0.2%	1.5%
Base Interest Rate	—	—	—
+25 Basis Points	2.2%	(0.3%)	(2.0%)
+50 Basis Points	3.7%	(0.6%)	(4.4%)
+75 Basis Points	4.5%	(0.9%)	(7.2%)
MBS Spread Shock (1)	Estimated Change in Portfolio Market Value	Estimated Change as a % on NAV (3)(4)	
-25 Basis Points	1.5%	11.5%	
-15 Basis Points	0.9%	6.9%	
-5 Basis Points	0.3%	2.3%	
Base Interest Rate	—	—	
+5 Basis Points	(0.3%)	(2.3%)	
+15 Basis Points	(0.9%)	(6.8%)	

+25 Basis Points	(1.5%)	(11.3%)

(1) Interest rate and MBS spread sensitivity are based on results from third party models in conjunction with inputs from our internal investment professionals. Actual results could differ materially from these estimates.
(2) Scenarios include Residential Investment Securities, commercial real estate investments, corporate debt, repurchase agreements, other secured financing and interest rate swaps. Economic net interest income includes interest expense on interest rate swaps.
(3) Scenarios include Residential Investment Securities, residential mortgage loans, MSRs and derivative instruments.
(4) NAV represents book value of equity.

Credit Risk Management

Key risk parameters have been established to specify our credit risk appetite. We will seek to manage credit risk by making investments which conform within the firm’s specific investment policy parameters and optimize risk-return attributes.

While we do not expect to encounter credit risk in our Agency investments, we face credit risk on the non-Agency mortgage-backed securities and CRT securities in our portfolio. In addition, we are also exposed to credit risk on residential mortgage loans, commercial real estate investments and corporate debt. MSR values may also be impacted if overall costs to service the underlying mortgage loans increase due to borrower performance. We are subject to risk of loss if an issuer or borrower fails to perform its contractual obligations. We have established policies and procedures for mitigating credit risk, including establishing and reviewing limits for credit exposure. We will originate or purchase commercial investments that meet our comprehensive underwriting process and credit standards and are approved by the appropriate committee. Once a

commercial investment is made, our ongoing surveillance process includes regular reviews, analysis and oversight of investments by our investment personnel and appropriate committee. We review credit and other risks of loss associated with each investment. Our management monitors the overall portfolio risk and determines estimates of provision for loss. Our portfolio composition at March 31, 2018 and December 31, 2017 was as follows:

Asset Portfolio (using balance sheet values)

Category	March 31, 2018		December 31, 2017	
Agency mortgage-backed securities	90.3	%	90.6	%
Credit risk transfer securities	0.6	%	0.7	%
Non-Agency mortgage-backed securities	1.1	%	1.1	%
Residential mortgage loans	1.6	%	1.4	%
Mortgage servicing rights	0.6	%	0.6	%
Commercial real estate (1)	4.6	%	4.6	%
Corporate debt	1.2	%	1.0	%

(1) Net of unamortized origination fees.

Counterparty Risk Management

Our use of repurchase and derivative agreements and trading activities create exposure to counterparty risk relating to potential losses that could be recognized if the counterparties to these agreements fail to perform their obligations under the contracts. In the event of default by a counterparty, we could have difficulty obtaining our assets pledged as collateral. A significant portion of our investments are financed with repurchase agreements by pledging our Residential Investment Securities and certain commercial real estate investments as collateral to the lender. The collateral we pledge generally exceeds the amount of the borrowings under each agreement. If the counterparty to the repurchase agreement defaults on its obligations and we are not able to recover our pledged asset, we are at risk of losing the over-collateralization or haircut. The amount of this exposure is the difference between the amount loaned to us plus interest due to the counterparty and the fair value of the collateral pledged by us to the lender including accrued interest receivable on such collateral.

We also use interest rate swaps and other derivatives to manage interest rate risk. Under these agreements, we pledge securities and cash as collateral or settle variation margin payments as part of a margin arrangement.

If a counterparty were to default on its obligations, we would be exposed to a loss to a derivative counterparty to the extent that the amount of our securities or cash pledged exceeded the unrealized loss on the associated derivative and we were not able to recover the excess collateral. Additionally, we would be exposed to a loss to a derivative counterparty to the extent that our unrealized gains on derivative instruments exceeded the amount of the counterparty's securities or cash pledged to us.

We monitor our exposure to counterparties across several dimensions including by type of arrangement, collateral type, counterparty type, ratings and geography.

The following table summarizes our exposure to counterparties by geography at March 31, 2018:

Country	Number of Counterparties	Repurchase Agreement Financing	Interest Rate Swaps at Fair Value	Exposure [1]
	(dollars in thousands)			
North America	31	$56,243,298	$(139,785)	$2,139,272
Europe	13	16,218,302	(218,944)	1,263,433
Asia (non-Japan)	1	457,099	—	30,745
Japan	4	5,096,732	—	335,657
Total	49	$78,015,431	$(358,729)	$3,769,107

(1) Represents the amount of cash and/or securities pledged as collateral to each counterparty less the aggregate of repurchase agreement financing and unrealized loss on swaps for each counterparty.

Operational Risk Management

We are subject to operational risk in each of our business and support functions. Operational risk may arise from internal or external sources including human error, fraud, systems issues, process change, vendors, business interruptions and other external events. Model risk considers potential errors with a model's results due to uncertainty in model parameters and inappropriate methodologies used. The result of these risks may include financial loss and reputational damage. We manage operational risk through a variety of tools including policies and procedures that cover topics such as business continuity, personal conduct, cybersecurity and vendor management. Other tools include testing, including disaster recovery testing; systems controls, including access controls; training, including cybersecurity awareness training; and monitoring, which includes the use of key risk indicators. Employee level lines of defense against operational risk include proper segregation of incompatible duties, activity-level internal controls over financial reporting, the empowerment of business units to identify and mitigate operational risk sources, testing by our internal audit staff, and our overall governance framework.

We have established a Cybersecurity Committee to help mitigate cybersecurity risks. The role of the committee is to oversee cyber risk assessments, monitor applicable key risk indicators, review cybersecurity training procedures, oversee the Company's Cybersecurity Incident Response Plan and engage third parties to conduct periodic penetration testing. Our cybersecurity risk assessment includes an evaluation of cyber risk related to sensitive data held by third parties on their systems. The Cybersecurity Committee periodically reports to the ERC, the BRC and the BAC. There is no assurance that these efforts will effectively mitigate cybersecurity risk and mitigation efforts are not an assurance that no cybersecurity incidents will occur. We have purchased cybersecurity insurance, however, there is no assurance that the insurance policy will cover all cybersecurity breaches or that the policy will cover all losses.

Compliance, Regulatory and Legal Risk Management

Our business is organized as a REIT, and we plan to continue to meet the requirements for taxation as a REIT. The determination that we are a REIT requires an analysis of various factual matters and circumstances. Accordingly, we closely monitor our REIT status within our risk management program.

The financial services industry is highly regulated and continues to receive increasing attention from regulators, which may impact both our company as well as our business strategy. We proactively monitor the potential impact regulation may have both directly and indirectly on us. We maintain a process to actively monitor both actual and potential legal action that may affect us. Our risk management

framework is designed to identify, monitor and manage these risks under the oversight of the ERC.

We currently rely on the exemption from registration provided by Section 3(c)(5)(C) of the Investment Company Act, and we plan to continue to meet the requirements for this exemption from registration. The determination that we qualify for this exemption from registration depends on various factual matters and circumstances. Accordingly, in conjunction with our legal department, we closely monitor our compliance with Section 3(c)(5)(C) within our risk management program. The monitoring of this risk is also under the oversight of the ERC.

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the U.S. Commodity Futures Trading Commission ("CFTC") gained jurisdiction over the regulation of interest rate swaps. The CFTC has asserted that this causes the operators of mortgage real estate investment trusts that use swaps as part of their business model to fall within the statutory definition of Commodity Pool Operator ("CPO"), and, absent relief from the Division of Swap Dealer and Intermediary Oversight or the CFTC, to register as CPOs. On December 7, 2012, as a result of numerous requests for no-action relief from the CPO registration requirement for operators of mortgage real estate investment trusts, the Division of Swap Dealer and Intermediary Oversight of the CFTC issued no-action relief entitled “No-Action Relief from the Commodity Pool Operator Registration Requirement for Commodity Pool Operators of Certain Pooled Investment Vehicles Organized as Mortgage Real Estate Investment Trusts” that permits a CPO to receive relief by filing a claim to perfect the use of the relief. A claim submitted by a CPO will be effective upon filing, so long as the claim is materially complete. The conditions that must be met relate to initial margin and premiums requirements, net income derived annually from commodity interest positions that are not qualifying hedging transactions, marketing of interests in the mortgage real estate investment trust to the public, and identification of the entity as a mortgage real estate investment trust in its federal tax filings with the Internal Revenue Service. While we disagree with the CFTC’s position that mortgage real estate investment trusts that use swaps as part of their business model fall within the statutory definition of a CPO, we have submitted a claim for the relief set forth in the no-action relief entitled “No-Action Relief from the Commodity Pool Operator Registration Requirement for Commodity Pool Operators of Certain Pooled Investment Vehicles Organized as Mortgage Real Estate Investment Trusts” and believe we meet the criteria for such relief set forth therein.

Critical Accounting Policies and Estimates

Our critical accounting policies that require us to make significant judgments or estimates are described below. For more information on these critical accounting policies and other significant accounting policies, see “Significant

Accounting Policies” in the Notes to the Consolidated Financial Statements.

Valuation of Financial Instruments

Residential Investment Securities

There is an active market for our Agency mortgage-backed securities, Agency debentures, CRT securities and non-Agency mortgage-backed securities. Since we primarily invest in securities that can be valued using actively quoted prices for actively traded assets, there is a high degree of observable inputs and less subjectivity in measuring fair value. Internal fair values are determined using quoted prices from the TBA securities market, the Treasury curve and the underlying characteristics of the individual securities, which may include coupon, periodic and life caps, reset dates and the expected life of the security. Prepayment rates are difficult to predict and require estimation and judgment in the valuation of Agency mortgage-backed securities. All internal fair values are compared to external pricing sources and/or dealer quotes to determine reasonableness. Additionally, securities used as collateral for repurchase agreements are priced daily by counterparties to ensure sufficient collateralization, providing additional verification of our internal pricing.

Residential Mortgage Loans

There is an active market for the residential whole loans in which we invest. Since we primarily invest in residential loans that can be valued using actively quoted prices for similar assets, there are observable inputs in measuring fair value. Internal fair values are determined using quoted prices for similar market transactions, the Treasury curve and the underlying characteristics of the individual loans, which may include loan term, coupon, and reset dates. Prepayment rates are difficult to predict and are a significant estimate requiring judgment in the valuation of residential whole loans. All internal fair values are compared to external pricing sources to determine reasonableness.

Commercial Real Estate Investments

The fair value of commercial mortgage-backed securities classified as available-for-sale is determined based upon quoted prices of similar assets in recent market transactions and requires the application of judgment due to differences in the underlying collateral. These securities must also be evaluated for other-than-temporary impairment if the fair value of the security is lower than its amortized cost. Determining whether there is an other-than-temporary impairment may require us to exercise significant judgment and make estimates to determine expected cash flows incorporating assumptions such as changes in interest rates and loss expectations. For commercial real estate loans and preferred equity investments classified as held for investment, we apply significant judgment in evaluating the

need for a loss reserve. Estimated net recoverable value of the commercial real estate loans and preferred equity investments and other factors such as the fair value of any collateral, the amount and status of senior debt, the prospects of the borrower and the competitive landscape where the borrower conducts business must be considered in determining the allowance for loan losses. For commercial real estate loans held for sale, significant judgment may need to be applied in determining fair value of the loans and whether a valuation allowance is necessary. Factors that may need to be considered to determine fair value of a loan held for sale include the borrower’s credit quality, liquidity and other market factors and the fair value of the underlying collateral.

Interest Rate Swaps

We use the overnight indexed swap (“OIS”) curve as an input to value substantially all of our uncleared interest rate swaps. We believe using the OIS curve, which reflects the interest rate typically paid on cash collateral, enables us to most accurately determine the fair value of uncleared interest rate swaps. Consistent with market practice, we exchange collateral (also called margin) based on the fair values of our interest rate swaps. Through this margining process, we may be able to compare our recorded fair value with the fair value calculated by the counterparty or derivatives clearing organization, providing additional verification of our recorded fair value of the uncleared interest rate swaps. We value our cleared interest rate swaps using the prices provided by the derivatives clearing organization.

Revenue Recognition

Interest income from coupon payments is accrued based on the outstanding principal amounts of the Residential Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Residential Investment Securities are amortized or accreted into interest income over the projected lives of the securities using the interest method. We use third-party model and market information to project prepayment speeds. Our prepayment speed projections incorporate underlying loan characteristics (i.e., coupon, term, original loan size, original loan-to-value ratio, etc.) and market data, including interest rate and home price index forecasts and expert judgment. Prepayment speeds vary according to the type of investment, conditions in the financial markets and other factors and cannot be predicted with any certainty. Changes to model assumptions, including interest rates and other market data, as well as periodic revisions to the model will cause changes in the results. Adjustments are made for actual prepayment activity as it relates to calculating the effective yield. Gains or losses on sales of Residential Investment Securities are recorded on trade date based on the specific identification method.

Consolidation of Variable Interest Entities

Determining whether an entity has a controlling financial interest in a VIE requires significant judgment related to assessing the purpose and design of the VIE and determination of the activities that most significantly impact its economic performance. We must also identify explicit and implicit variable interests in the entity and consider our involvement in both the design of the VIE and its ongoing activities. To determine whether consolidation of the VIE is required, we must apply judgment to assess whether we have the power to direct the most significant activities of the VIE and whether we have either the rights to receive benefits or the obligation to absorb losses that could be potentially significant to the VIE.

Use of Estimates

The use of GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Glossary of Terms

A

Adjustable-Rate Loan / Security
A loan / security on which interest rates are adjusted at regular intervals according to predetermined criteria. The adjustable interest rate is tied to an objective, published interest rate index.

Agency
Refers to a federally chartered corporation, such as the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, or an agency of the U.S. Government, such as the Government National Mortgage Association.

Agency Debentures
Debt issued by a federal agency or a government-sponsored enterprise ("GSE") for financing purposes. These types of debentures are not backed by collateral, but by the integrity and credit-worthiness of the issuer. Agency debentures issued by a GSE are backed only by that GSE's ability to pay. The callable feature allows the Agency to repay the bond prior to maturity.

Agency Mortgage-Backed Securities
Refers to residential mortgage-backed securities that are issued or guaranteed by an Agency.

Amortization
Liquidation of a debt through installment payments. Amortization also refers to the process of systematically reducing a recognized asset or liability (e.g., a purchase premium or discount for a debt security) with an offset to earnings.

Average Life
On a mortgage-backed security, the average time to receipt of each dollar of principal, weighted by the amount of each principal prepayment, based on prepayment assumptions.

B

Basis Point ("BP")
One hundredth of one percent, used in expressing differences in interest rates. One basis point is 0.01% of yield. For example, a bond's yield that changed from 3.00% to 3.50% would be said to have moved 50 basis points.

Benchmark
A bond or an index referencing a basket of bonds whose terms are used for comparison with other bonds of similar maturity. The global financial market typically looks to U.S. Treasury securities as benchmarks.

Beneficial Owner
One who benefits from owning a security, even if the security's title of ownership is in the name of a broker or bank.

B-Note

Subordinate mortgage notes and/or subordinate mortgage loan participations.

B-Piece
The most subordinate commercial mortgage-backed security bond class.

Board
Refers to the board of directors of Annaly.

Bond
The written evidence of debt, bearing a stated rate or stated rates of interest, or stating a formula for determining that rate, and maturing on a date certain, on which date and upon presentation a fixed sum of money plus interest (usually represented by interest coupons attached to the bond) is payable to the holder or owner. Bonds are long-term securities with an original maturity of greater than one year. For purposes of computations tied in to "per bond," a $1,000 increment of an issue is used (no matter what the actual denominations are).

Book Value Per Share
Calculated by summing common stock, additional paid-in capital, accumulated other comprehensive income (loss) and accumulated deficit and dividing that number by the total common shares outstanding.

Broker
Generic name for a securities firm engaged in both buying and selling securities on behalf of customers or its own account.

C

Capital Buffer
Includes unencumbered financial assets which can be either sold or utilized as collateral to meet liquidity needs.

Capital Ratio
Calculated as total stockholders' equity divided by total assets inclusive of outstanding market value of TBA positions and exclusive of consolidated VIEs.

Carry
The amount an asset earns over its hedging and financing costs. A positive carry happens when the rate on the securities being financed is greater than the rate on the funds borrowed. A negative carry is when the rate on the funds borrowed is greater than the rate on the securities that are being financed.

Collateral
Securities, cash or property pledged by a borrower or party to a derivative contract to secure payment of a loan or derivative. If the borrower fails to repay the loan or defaults under the derivative contract, the secured party may take ownership of the collateral.

Collateralized Mortgage Obligation ("CMO")
A multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans.

Commodity Futures Trading Commission ("CFTC")
An independent U.S. federal agency established by the Commodity Futures Trading Commission Act of 1974. The CFTC regulates the swaps, commodity futures and options markets. Its goals include the promotion of competitive and efficient futures markets and the protection of investors against manipulation, abusive trade practices and fraud.

Commercial Mortgage-Backed Security ("CMBS")
Securities collateralized by a pool of mortgages on commercial real estate in which all principal and interest from the mortgages flow to certificate holders in a defined sequence or manner.

Constant Prepayment Rate ("CPR")
The percentage of outstanding mortgage loan principal that prepays in one year, based on the annualization of the Single Monthly Mortality, which reflects the outstanding mortgage loan principal that prepays in one month.

Convertible Securities
Securities which may be converted into shares of another security under stated terms, often into the issuing company's common stock.

Convexity
A measure of the change in a security's duration with respect to changes in interest rates. The more convex a security is, the more its duration will change with interest rate changes.

Core Earnings and Core Earnings Per Average Common Share
Non-GAAP measure that is defined as net income (loss) excluding gains or losses on disposals of investments and termination or maturity of interest rate swaps, unrealized gains or losses on interest rate swaps and investments measured at fair value through earnings, net gains (losses) on trading assets, impairment losses, net income (loss) attributable to noncontrolling interest, transaction expenses and certain other non-recurring gains or losses, and inclusive of TBA dollar roll income (a component of Net gains (losses) on trading assets) and realized amortization of MSRs. Core earnings per average common share is calculated by dividing core earnings by average basic common shares for the period.

Corporate Debt
Non-government debt instruments issued by corporations. Long-term corporate debt can be issued as bonds or loans.

Counterparty
One of two entities in a transaction. For example, in the bond market a counterparty can be a state or local government, a broker-dealer or a corporation.

Coupon

The interest rate on a bond that is used to compute the amount of interest due on a periodic basis.

Credit and Counterparty Risk
Risk to earnings, capital or business, resulting from an obligor's or counterparty's failure to meet the terms of any contract or otherwise failure to perform as agreed. Credit and counterparty risk is present in lending, investing, funding and hedging activities.

Credit Derivatives
Derivative instruments that have one or more underlyings related to the credit risk of a specified entity (or group of entities) or an index that exposes the seller to potential loss from specified credit-risk related events. An example is credit derivatives referencing the commercial mortgage-backed securities index.

Credit Risk Transfer ("CRT") Securities
Credit Risk Transfer securities are risk sharing transactions issued by Fannie Mae and Freddie Mac and similarly structured transactions arranged by third party market participants. The securities issued in the CRT sector are designed to synthetically transfer mortgage credit risk from Fannie Mae, Freddie Mac and/or third parties to private investors.

Current Face
The current remaining monthly principal on a mortgage security. Current face is computed by multiplying the original face value of the security by the current principal balance factor.

D

Dealer
Person or organization that underwrites, trades and sells securities, e.g., a principal market-maker in securities.

Default Risk
Possibility that a bond issuer will fail to pay principal or interest when due.

Derivative
A financial product that derives its value from the price, price fluctuations and price expectations of an underlying instrument, index or reference pool (e.g. futures contracts, options, interest rate swaps, interest rate swaptions and certain to-be-announced securities).

Discount Price
When the dollar price is below face value, it is said to be selling at a discount.

Duration
The weighted maturity of a fixed-income investment’s cash flows, used in the estimation of the price sensitivity of fixed-income securities for a given change in interest rates.

E

Economic Capital
A measure of the risk a firm is subject to. It is the amount of capital a firm needs as a buffer to protect against risk. It is a probabilistic measure of potential future losses at a given confidence level over a given time horizon.

Economic Interest Expense
Non-GAAP financial measure that is composed of GAAP interest expense adjusted for realized gains or losses on interest rate swaps.

Economic Leverage Ratio (Economic Debt-to-Equity Ratio)
Calculated as the sum of recourse debt, TBA derivative notional outstanding and net forward purchases of investments divided by total equity.

Economic Net Interest Income
Non-GAAP financial measure that is composed of GAAP net interest income adjusted for realized gains or losses on interest rate swaps used to hedge cost of funds.

Encumbered Assets
Assets on the company’s balance sheet which have been pledged as collateral against a liability.

Eurodollar
A U.S. dollar deposit held in Europe or elsewhere outside the United States.

F

Face Amount
The par value (i.e., principal or maturity value) of a security appearing on the face of the instrument.

Factor
A decimal value reflecting the proportion of the outstanding principal balance of a mortgage security, which changes over time, in relation to its original principal value.

Fannie Mae
Federal National Mortgage Association.

Federal Deposit Insurance Corporation (“FDIC”)
An independent agency created by the U.S. Congress to maintain stability and public confidence in the nation’s financial system by insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing receiverships.

Federal Funds Rate
The interest rate charged by banks on overnight loans of their excess reserve funds to other banks.

Federal Home Loan Banks (“FHLB”)
U.S. Government-sponsored banks that provide reliable liquidity to member financial institutions to support housing finance and community investment.

Federal Housing Financing Agency (“FHFA”)
The FHFA is an independent regulatory agency that oversees vital components of the secondary mortgage market including Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

Financial Industry Regulatory Authority (“FINRA”)
FINRA is a non-governmental organization tasked with regulating all business dealings conducted between dealers, brokers and all public investors.

Fixed-Rate Mortgage
A mortgage featuring level monthly payments, determined at the outset, which remain constant over the life of the mortgage.

Fixed Income Clearing Corporation (“FICC”)
The FICC is an agency that deals with the confirmation, settlement and delivery of fixed-income assets in the U.S. The agency ensures the systematic and efficient settlement of U.S. Government securities and mortgage-backed security transactions in the market.

Floating Rate Bond
A bond for which the interest rate is adjusted periodically according to a predetermined formula, usually linked to an index.

Floating Rate CMO
A CMO tranche which pays an adjustable rate of interest tied to a representative interest rate index such as the LIBOR, the Constant Maturity Treasury or the Cost of Funds Index.

Freddie Mac
Federal Home Loan Mortgage Corporation.

Futures Contract
A legally binding agreement to buy or sell a commodity or financial instrument in a designated future month at a price agreed upon at the initiation of the contract by the buyer and seller. Futures contracts are standardized according to the quality, quantity, and delivery time and location for each commodity. A futures contract differs from an option in that an option gives one of the counterparties a right and the other an obligation to buy or sell, while a futures contract represents an obligation of both counterparties, one to deliver and the other to accept delivery. A futures contract is part of a class of financial instruments called derivatives.

G

GAAP
U.S. generally accepted accounting principles.

Ginnie Mae
Government National Mortgage Association.

H

Hedge
An investment made with the intention of minimizing the impact of adverse movements in interest rates or securities prices.

I

In-the-Money
Description for an option that has intrinsic value and can be sold or exercised for a profit; a call option is in-the-money when the strike price (execution price) is below the market price of the underlying security.

Interest Bearing Liabilities
Refers to repurchase agreements, securitized debt of consolidated VIEs, participation sold, FHLB Des Moines advances, credit facilities, U.S. Treasury securities sold, not yet purchased and securities loaned. Average Interest Bearing Liabilities is based on daily balances.

Interest Earning Assets
Refers to Residential Investment Securities, securities borrowed, U.S. Treasury securities, reverse repurchase agreements, commercial real estate debt investments, commercial real estate debt and preferred equity interests, residential mortgage loans and corporate debt. Average Interest Earning Assets is based on daily balances.

Interest-Only (IO) Bond
The interest portion of mortgage, Treasury or bond payments, which is separated and sold individually from the principal portion of those same payments.

Interest Rate Risk
The risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. As market interest rates rise, the value of current fixed income investment holdings declines. Diversifying, deleveraging and hedging techniques are utilized to mitigate this risk. Interest rate risk is a form of market risk.

Interest Rate Swap
A binding agreement between counterparties to exchange periodic interest payments on some predetermined dollar principal, which is called the notional principal amount. For example, one party will pay fixed and receive a variable rate .

Interest Rate Swaption
Options on interest rate swaps. The buyer of a swaption has the right to enter into an interest rate swap agreement at some specified date in the future. The swaption agreement will specify whether the buyer of the swaption will be a fixed-rate receiver or a fixed-rate payer.

Internal Capital Adequacy Assessment Program ("ICAAP")
The ongoing assessment and measurement of risks, and the amount of capital which is necessary to hold against those risks. The objective is to ensure that a firm is appropriately capitalized relative to the risks in its business.

International Swaps and Derivatives Association ("ISDA") Master Agreement
Standardized contract developed by ISDA used as an umbrella under which bilateral derivatives contracts are entered into.

Inverse IO Bond
An interest-only bond whose coupon is determined by a formula expressing an inverse relationship to a benchmark rate, such as LIBOR. As the benchmark rate changes, the IO coupon adjusts in the opposite direction. When the benchmark rate is relatively low, the IO pays a relatively high coupon payment, and vice versa.

Investment/Market Risk
Risk to earnings, capital or business resulting in the decline in value of our assets caused from changes in market variables, such as interest rates, which affect the values of Residential Investment Securities and other investment instruments.

Investment Company Act
Refers to the Investment Company Act of 1940, as amended.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 2. Management's Discussion And Analysis

L

Leverage
The use of borrowed money to increase investing power and economic returns.

Leverage Ratio (Debt-to-Equity Ratio)
Calculated as total debt to total stockholders' equity. For purposes of calculating this ratio total debt includes repurchase agreements, other secured financing, securitized debt of consolidated VIEs, loan participation sold and mortgages payable which are non-recourse to us, subject to customary carveouts.

LIBOR (London Interbank Offered Rate)
The rate banks charge each other for short-term Eurodollar loans. LIBOR is frequently used as the base for resetting rates on floating-rate securities and the floating-rate legs of interest rate swaps.

Liquidity Risk
Risk to earnings, capital or business arising from our inability to meet our obligations when they come due without incurring unacceptable losses because of inability to liquidate assets or obtain adequate funding.

Long-Term CPR
The Company's projected prepayment speeds for certain Agency mortgage-backed securities using third-party model and market information. The Company's prepayment speed projections incorporate underlying loan characteristics (e.g., coupon, term, original loan size, original loan-to-value ratio, etc.) and market data, including interest rate and home price index forecasts. Changes to model assumptions, including interest rates and other market data, as well as periodic revisions to the model will cause changes in the results.

Long-Term Debt
Debt which matures in more than one year.

M

Market Agreed Coupon ("MAC") Interest Rate Swap
An interest rate swap contract structure with pre-defined, market agreed terms, developed by SIFMA and ISDA with the purpose of promoting liquidity and simplified administration.

Monetary Policy
Action taken by the Board of Governors of the Federal Reserve System to influence the money supply or interest rates.

Mortgage-Backed Security ("MBS")
A security representing a direct interest in a pool of mortgage loans. The pass-through issuer or servicer collects the payments on the loans in the pool and "passes through" the

principal and interest to the security holders on a pro rata basis.

Mortgage Loan

A mortgage loan granted by a bank, thrift or other financial institution that is based solely on real estate as security and is not insured or guaranteed by a government agency.

Mortgage Servicing Rights (“MSRs”)
Contractual agreements constituting the right to service an existing mortgage where the holder receives the benefits and bears the costs and risks of servicing the mortgage.

N

NAV
Net asset value.

Net Equity Yield
Calculated using GAAP net income, excluding depreciation and amortization expense, divided by average net equity.

Net Interest Income
Represents interest income earned on our portfolio investments, less interest expense paid for borrowings.

Net Interest Margin
Represents the sum of the Company's interest income plus TBA dollar roll income less interest expense and realized gains (losses) on interest rate swaps divided by the sum of average Interest Earning Assets plus average TBA contract balances.

Net Interest Spread
Calculated by taking the average yield on Interest Earning Assets minus the average cost of Interest Bearing Liabilities, including the net interest payments on interest rate swaps used to hedge cost of funds.

Non-Performing Loan (“NPL”)
A loan that is close to defaulting or is in default.

Notional Amount
A stated principal amount in a derivative contract on which the contract is based.

O

Operational Risk
Risk to earnings, capital, reputation or business arising from inadequate or failed internal processes or systems, human factors or external events.

Option Contract
A contract in which the buyer has the right, but not the obligation, to buy or sell an asset at a set price on or before a given date. Buyers of call options bet that a security will be

worth more than the price set by the option (the strike price), plus the price they pay for the option itself. Buyers of put options bet that the security's price will drop below the price set by the option. An option is part of a class of financial instruments called derivatives, which means these financial instruments derive their value from the worth of an underlying investment.

Original Face
The face value or original principal amount of a security on its issue date.

Out-of-the-Money
Description for an option that has no intrinsic value and would be worthless if it expired today; for a call option, this situation occurs when the strike price is higher than the market price of the underlying security; for a put option, this situation occurs when the strike price is less than the market price of the underlying security.

Over-The-Counter ("OTC") Market
A securities market that is conducted by dealers throughout the country through negotiation of price rather than through the use of an auction system as represented by a stock exchange.

P

Par
Price equal to the face amount of a security; 100%.

Par Amount
The principal amount of a bond or note due at maturity. Also known as par value.

Pass-Through Security
A securitization structure where a GSE or other entity "passes" the amount collected from the borrowers every month to the investor, after deducting fees and expenses.

Pool
A collection of mortgage loans assembled by an originator or master servicer as the basis for a security. In the case of Ginnie Mae, Fannie Mae, or Freddie Mac mortgage pass-through securities, pools are identified by a number assigned by the issuing agency.

Premium
The amount by which the price of a security exceeds its principal amount. When the dollar price of a bond is above its face value, it is said to be selling at a premium.

Premium Amortization Adjustment ("PAA")
The component of premium amortization representing the quarter-over-quarter change in estimated long-term CPR.

Prepayment
The unscheduled partial or complete payment of the principal amount outstanding on a mortgage loan or other debt before it is due.

Prepayment Risk
The risk that falling interest rates will lead to increased prepayments of mortgage or other loans, forcing the investor to reinvest at lower prevailing rates.

Prime Rate
The indicative interest rate on loans that banks quote to their best commercial customers.

Principal and Interest
The term used to refer to regularly scheduled payments or prepayments of principal and payments of interest on a mortgage or other security.

R

Rate Reset
The adjustment of the interest rate on a floating-rate security according to a prescribed formula.

Real Estate Investment Trust ("REIT")
A special purpose investment vehicle that provides investors with the ability to participate directly in the ownership or financing of real-estate related assets by pooling their capital to purchase and manage mortgage loans and/or income property.

Recourse Debt
Debt on which the economic borrower is obligated to repay the entire balance regardless of the value of the pledged collateral. By contrast, the economic borrower's obligation to repay non-recourse debt is limited to the value of the pledged collateral. Recourse debt consists of repurchase agreements, and other secured financing.

Reinvestment Risk
The risk that interest income or principal repayments will have to be reinvested at lower rates in a declining rate environment.

Re-Performing Loan ("RPL")
A type of loan in which payments were previously delinquent by at least 90 days but have resumed.

Repurchase Agreement
The sale of securities to investors with the agreement to buy them back at a higher price after a specified time period; a form of short-term borrowing. For the party on the other end of the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement.

Residential Investment Securities
Refers to Agency mortgage-backed securities, Agency debentures, CRT securities and non-Agency mortgage-backed securities.

Residual
In a CMO, the residual is the tranche that collects any cash flow from the collateral that remains after obligations to the other tranches have been met.

Return on Average Equity
Calculated by taking earnings divided by average stockholders' equity.

Reverse Repurchase Agreement
Refer to Repurchase Agreement. The buyer of securities effectively provides a collateralized loan to the seller.

Risk Appetite Statement
Defines the types and levels of risk we are willing to take in order to achieve our business objectives, and reflects our risk management philosophy.

S

Secondary Market
Ongoing market for bonds previously offered or sold in the primary market.

Settlement Date
The date securities must be delivered and paid for to complete a transaction.

Short-Term Debt
Generally, debt which matures in one year or less. However, certain securities that mature in up to three years may be considered short-term debt.

Spread
When buying or selling a bond through a brokerage firm, an individual investor will be charged a commission or spread, which is the difference between the market price and cost of purchase, and sometimes a service fee. Spreads differ based on several factors including liquidity.

T

Target Assets
Includes Agency mortgage-backed securities, to-be-announced forward contracts, Agency debentures, CRT securities, MSRs, non-Agency mortgage-backed securities, residential mortgage loans, commercial real estate investments, and corporate debt.

To-Be-Announced Securities ("TBAs")
A contract for the purchase or sale of a mortgage-backed security to be delivered at a predetermined price, face amount,

issuer, coupon and stated maturity on an agreed-upon future date but does not include a specified pool number and number of pools.

TBA Dollar Roll Income
TBA dollar roll income is defined as the difference in price between two TBA contracts with the same terms but different settlement dates. The TBA contract settling in the later month typically prices at a discount to the earlier month contract with the difference in price commonly referred to as the “drop”. TBA dollar roll income represents the equivalent of interest income on the underlying security less an implied cost of financing.

Total Return
Investment performance measure over a stated time period which includes coupon interest, interest on interest, and any realized and unrealized gains or losses.

Total Return Swap
A derivative instrument where one party makes payments at a predetermined rate (either fixed or variable) while receiving a return on a specific asset (generally an equity index, loan or bond) held by the counterparty.

U

Unencumbered Assets
Assets on our balance sheet which have not been pledged as collateral against an existing liability.

U.S. Government-Sponsored Enterprise (“GSE”) Obligations
Obligations of Agencies originally established or chartered by the U.S. government to serve public purposes as specified by the U.S. Congress, such as Fannie Mae and Freddie Mac; these obligations are not explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

V

Value-at-Risk (“VaR”)
A statistical technique which measures the potential loss in value of an asset or portfolio over a defined period for a given confidence interval.

Variable Interest Entity (“VIE”)
An entity in which equity investors (i) do not have the characteristics of a controlling financial interest, and/or (ii) do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties.

Variation Margin
Cash or securities provided by a party to collateralize its obligations under a transaction as a result of a change in value

of such transaction since the trade was executed or the last time collateral was provided.

Volatility
A statistical measure of the variance of price or yield over time. Volatility is low if the price does not change very much over a short period of time, and high if there is a greater change.

W

Warehouse Lending
A line of credit extended to a loan originator to fund mortgages extended by the loan originators to property purchasers. The loan typically lasts from the time the mortgage is originated to when the mortgage is sold into the secondary market, whether directly or through a securitization. Warehouse lending can provide liquidity to the loan origination market.

Weighted Average Coupon
The weighted average interest rate of the underlying mortgage loans or pools that serve as collateral for a security, weighted by the size of the principal loan balances.

Weighted Average Life (“WAL”)
The assumed weighted average amount of time that will elapse from the date of a security’s issuance until each dollar of principal is repaid to the investor. The WAL will change as the security ages and depending on the actual realized rate at which principal, scheduled and unscheduled, is paid on the loans underlying the MBS.

Y

Yield-to-Maturity
The expected rate of return of a bond if it is held to its maturity date; calculated by taking into account the current market price, stated redemption value, coupon payments and time to maturity and assuming all coupons are reinvested at the same rate; equivalent to the internal rate of return.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Quantitative and qualitative disclosures about market risk are contained within the section titled “Risk Management” of Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

ITEM 4. CONTROLS AND PROCEDURES

Our management, including our Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), reviewed and evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act) as of the end of the period covered by this report. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed, (1) were effective in ensuring that information required to be disclosed by the Company in reports it files or submits under the Securities Exchange Act is accumulated and communicated to our management, including our CEO

and CFO, as appropriate to allow timely decisions regarding required disclosure and (2) were effective in ensuring that information required to be disclosed by the Company in reports it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC’s rules and forms.

There have been no changes in our internal controls over financial reporting that occurred during the three months ended March 31, 2018 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are involved in various claims and legal actions arising in the ordinary course of business.

At March 31, 2018, we were not party to any pending material legal proceedings.

ITEM 1A. RISK FACTORS

Other than the following risk factors relating to the pending MTGE Acquisition, there have been no material changes to the risk factors disclosed in Item 1A. "Risk Factors" of our most recent annual report on Form 10-K. The materialization of any risks and uncertainties identified in our Special Note Regarding Forward-Looking Statements contained in this report together with those previously disclosed in our most recent annual report on Form 10-K or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations – Special Note Regarding Forward-Looking Statements" in this quarterly report or our most recent annual report on Form 10-K.

Risks Related to the MTGE Acquisition

Completion of the MTGE Acquisition remains subject to conditions that we cannot control.

The MTGE Acquisition is subject to various closing conditions, including the receipt of specified regulatory approvals. There are no assurances that all of the conditions necessary to consummate the MTGE Acquisition will be satisfied or that the conditions will be satisfied in the time frame expected.

Failure to consummate the MTGE Acquisition could negatively impact the share price of our common stock and our future business and financial results.

If the MTGE Acquisition is not consummated, our businesses may be adversely affected and, without realizing any of the potential benefits of having consummated the MTGE Acquisition, we will be subject to a number of risks, including the following:

- we will be required to pay certain costs and expenses relating to the MTGE Acquisition; and
- matters relating to the MTGE Acquisition (including integration planning) may require substantial commitments of time and resources by our management, which could otherwise have been devoted to other opportunities that may have been beneficial to us.

If the MTGE Acquisition is not consummated, these risks may materialize and may adversely affect our business, financial results and share price.

Risks Related to Annaly Following the MTGE Acquisition

We may fail to realize all of the expected benefits of the MTGE Acquisition or those benefits may take longer to realize than expected.

The full benefits of the MTGE Acquisition may not be realized as expected or may not be achieved within the anticipated time-frame, or at all. Failure to achieve the anticipated benefits of the MTGE Acquisition could adversely affect our results of operations or cash flows, cause dilution to our earnings per share or book value per share, decrease or delay the expected accretive effect of the MTGE Acquisition, and negatively impact the share price of our common stock.

In addition, we will be required to devote significant attention and resources prior to closing to prepare for the post-closing operation of Annaly, as the combined company. Post-closing, Annaly, as the combined company, will be required to devote significant attention and resources to successfully integrate the MTGE portfolio and operating businesses into the existing Annaly structure. In particular, prior to the acquisition, we will have limited experience operating MTGE's healthcare and senior living facilities portfolio. This business present additional regulatory constraints and poses operational risks different from those that we have successfully managed in the past. This integration process, coupled with managing a new business line, may disrupt our businesses and, if ineffective, would limit the anticipated benefits of the MTGE Acquisition and could adversely affect our results of operations or cash flows, cause dilution to our earnings per share or book value per share, decrease or delay the expected accretive effect of the MTGE Acquisition, and negatively impact the share price of our common stock.

We will incur direct and indirect costs as a result of the MTGE Acquisition.

We will incur substantial expenses in connection with and as a result completing the MTGE Acquisition and, following completion, we expect to incur additional expenses in connection with combining the businesses, operations, policies and procedures of the two companies. Factors beyond our control could affect the total amount or timing of these expenses, many of which, by their nature, are difficult to estimate accurately.

Risks Related to MTGE’s Business

You should read and consider risk factors specific to MTGE’s business that will also affect the combined company after the MTGE Acquisition. These risks are described in Part I, Item 1A of MTGE’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017, and in other documents filed with the SEC.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 6. Exhibits

ITEM 6. EXHIBITS

Exhibits:

The exhibits required by this item are set forth on the Exhibit Index attached hereto.

Exhibit Number	Exhibit Description
31.1	Certification of Kevin G. Keyes, Chief Executive Officer, President and Director (Principal Executive Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Glenn A. Votek, Chief Financial Officer (Principal Financial Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Kevin G. Keyes, Chief Executive Officer, President and Director (Principal Executive Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Glenn A. Votek, Chief Financial Officer (Principal Financial Officer) of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 101.INS XBRL	Instance Document †
Exhibit 101.SCH XBRL	Taxonomy Extension Schema Document †
Exhibit 101.CAL XBRL	Taxonomy Extension Calculation Linkbase Document †
Exhibit 101.DEF XBRL	Additional Taxonomy Extension Definition Linkbase Document Created†
Exhibit 101.LAB XBRL	Taxonomy Extension Label Linkbase Document †
Exhibit 101.PRE XBRL	Taxonomy Extension Presentation Linkbase Document †

† Submitted electronically herewith. Attached as Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Financial Condition at March 31, 2018 (Unaudited) and December 31, 2017 (Derived from the audited Consolidated Statement of Financial Condition at December 31, 2017); (ii) Consolidated Statements of Comprehensive Income (Loss) (Unaudited) for the three months ended March 31, 2018 and 2017; (iii) Consolidated Statements of Stockholders' Equity (Unaudited) for the three months ended March 31, 2018 and 2017; (iv) Consolidated Statements of Cash Flows (Unaudited) for the three months ended March 31, 2018 and 2017; and (v) Notes to Consolidated Financial Statements (Unaudited).

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of New York, State of New York.

		ANNALY CAPITAL MANAGEMENT, INC.
Dated:	May 3, 2018	By: /s/ Kevin G. Keyes Kevin G. Keyes Chief Executive Officer, President and Director (Principal Executive Officer)
Dated:	May 3, 2018	By: /s/ Glenn A. Votek Glenn A. Votek Chief Financial Officer (Principal Financial Officer)