

PRINCIPAL FINANCIAL GROUP INC

Form 10-Q

November 01, 2017

[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

---

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

**For the quarterly period ended September 30, 2017**

**OR**

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

---

**1-16725**

(Commission file number)

**PRINCIPAL FINANCIAL GROUP, INC.**

(Exact name of registrant as specified in its charter)

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

**Delaware**

(State or other jurisdiction of incorporation or organization)

**42-1520346**

(I.R.S. Employer Identification Number)

**711 High Street, Des Moines, Iowa 50392**

(Address of principal executive offices)

**(515) 247-5111**

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definitions of large accelerated filer, accelerated filer, smaller reporting company and emerging growth company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company  Emerging growth company   
(Do not check if a smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The total number of shares of the registrant's Common Stock, \$0.01 par value, outstanding as of October 25, 2017, was 288,754,689.

Table of Contents

PRINCIPAL FINANCIAL GROUP, INC.

TABLE OF CONTENTS

	<b>Page</b>
<u>Part I - FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	
<u>Financial Statements</u>	3
<u>Consolidated Statements of Financial Position as of September 30, 2017 (Unaudited) and December 31, 2016</u>	3
<u>Unaudited Consolidated Statements of Operations for the three and nine months ended September 30, 2017 and 2016</u>	4
<u>Unaudited Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2017 and 2016</u>	5
<u>Unaudited Consolidated Statements of Stockholders' Equity for the nine months ended September 30, 2017 and 2016</u>	6
<u>Unaudited Consolidated Statements of Cash Flows for the nine months ended September 30, 2017 and 2016</u>	7
<u>Notes to Unaudited Consolidated Financial Statements - September 30, 2017</u>	8
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	92
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	126
<u>Item 4.</u>	
<u>Controls and Procedures</u>	132
<u>Part II - OTHER INFORMATION</u>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	133
<u>Item 1A.</u>	
<u>Risk Factors</u>	133
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	133
<u>Item 6.</u>	
<u>Exhibits</u>	134
<u>Signature</u>	136

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

	September 30, 2017 (Unaudited)	December 31, 2016
	<i>(in millions)</i>	
<b>Assets</b>		
Fixed maturities, available-for-sale (2017 and 2016 include \$257.4 million and \$232.5 million related to consolidated variable interest entities)	\$ 59,137.8	\$ 54,846.1
Fixed maturities, trading (2017 and 2016 include \$0.0 million and \$82.4 million related to consolidated variable interest entities)	232.5	398.4
Equity securities, available-for-sale	118.3	98.9
Equity securities, trading (2017 and 2016 include \$788.3 million and \$721.9 million related to consolidated variable interest entities)	1,670.9	1,413.4
Mortgage loans	14,020.4	13,230.2
Real estate (2017 and 2016 include \$291.9 million and \$305.7 million related to consolidated variable interest entities)	1,650.2	1,368.8
Policy loans	812.0	823.8
Other investments (2017 and 2016 include \$105.5 million and \$89.8 million related to consolidated variable interest entities and \$88.9 million and \$86.2 million measured at fair value under the fair value option)	3,561.3	3,655.9
Total investments	81,203.4	75,835.5
Cash and cash equivalents	2,795.0	2,719.6
Accrued investment income	634.6	580.6
Premiums due and other receivables	1,516.6	1,361.9
Deferred acquisition costs	3,481.4	3,380.2
Property and equipment	754.6	699.0
Goodwill	1,055.2	1,020.8
Other intangibles	1,314.7	1,325.3
Separate account assets (2017 and 2016 include \$39,725.2 million and \$35,844.1 million related to consolidated variable interest entities)	154,085.9	139,832.6
Other assets	1,092.2	1,258.8
Total assets	\$ 247,933.6	\$ 228,014.3
<b>Liabilities</b>		
Contractholder funds (2017 and 2016 include \$374.5 million and \$358.7 million related to consolidated variable interest entities)	\$ 38,208.6	\$ 37,953.6
Future policy benefits and claims	32,129.1	29,000.7
Other policyholder funds	926.2	890.4
Short-term debt	58.8	51.4
Long-term debt	3,175.4	3,125.7
Income taxes currently payable	53.7	12.9
Deferred income taxes	1,515.2	972.4
Separate account liabilities (2017 and 2016 include \$39,725.2 million and \$35,844.1 million related to consolidated variable interest entities)	154,085.9	139,832.6
Other liabilities (2017 and 2016 include \$259.2 million and \$284.1 million related to consolidated variable interest entities, of which \$0.0 million and \$59.9 million are measured at fair value under the fair value option)	5,584.3	5,783.3
Total liabilities	235,737.2	217,623.0

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

Redeemable noncontrolling interest (2017 and 2016 include \$50.1 million and \$58.8 million related to consolidated variable interest entities)	129.1	97.5
<b>Stockholders' equity</b>		
Common stock, par value \$.01 per share 2,500.0 million shares authorized, 473.5 million and 469.2 million shares issued, and 288.5 million and 287.7 million shares outstanding in 2017 and 2016	4.7	4.7
Additional paid-in capital	9,886.8	9,686.0
Retained earnings	8,784.6	7,720.4
Accumulated other comprehensive income (loss)	47.0	(675.2)
Treasury stock, at cost (185.0 million and 181.5 million shares in 2017 and 2016)	(6,726.7)	(6,508.6)
Total stockholders' equity attributable to Principal Financial Group, Inc.	11,996.4	10,227.3
Noncontrolling interest	70.9	66.5
Total stockholders' equity	12,067.3	10,293.8
Total liabilities and stockholders' equity	\$ 247,933.6	\$ 228,014.3

*See accompanying notes.*

Table of Contents

## Principal Financial Group, Inc.

## Consolidated Statements of Operations

(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2017	2016	2017	2016
	<i>(in millions, except per share data)</i>			
<b>Revenues</b>				
Premiums and other considerations	\$ 2,126.1	\$ 1,002.7	\$ 4,826.8	\$ 3,561.1
Fees and other revenues	987.1	915.0	2,882.8	2,687.7
Net investment income	838.0	856.1	2,581.8	2,417.0
Net realized capital gains, excluding impairment losses on available-for-sale securities	693.2	55.5	623.7	283.9
Net other-than-temporary impairment (losses) recoveries on for-sale securities	2.6	(22.0)	(27.1)	(81.0)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income	(19.2)	10.7	(32.5)	11.6
Net impairment losses on available-for-sale securities	(16.6)	(11.3)	(59.6)	(69.4)
Net realized capital gains	676.6	44.2	564.1	214.5
Total revenues	4,627.8	2,818.0	10,855.5	8,880.3
<b>Expenses</b>				
Benefits, claims and settlement expenses	2,504.6	1,482.2	6,020.7	4,800.6
Dividends to policyholders	32.6	45.5	92.7	122.3
Operating expenses	932.8	919.6	2,804.7	2,747.0
Total expenses	3,470.0	2,447.3	8,918.1	7,669.9
Income before income taxes	1,157.8	370.7	1,937.4	1,210.4
Income taxes	344.6	43.3	455.8	186.8
Net income	813.2	327.4	1,481.6	1,023.6
Net income attributable to noncontrolling interest	3.0	19.2	13.0	25.1
Net income attributable to Principal Financial Group, Inc.	\$ 810.2	\$ 308.2	\$ 1,468.6	\$ 998.5
<b>Earnings per common share</b>				
Basic earnings per common share	\$ 2.80	\$ 1.07	\$ 5.08	\$ 3.45
Diluted earnings per common share	\$ 2.76	\$ 1.06	\$ 5.02	\$ 3.41
<b>Dividends declared per common share</b>	\$ 0.47	\$ 0.41	\$ 1.38	\$ 1.18

See accompanying notes.

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2017	2016	2017	2016
	<i>(in millions)</i>			
Net income	\$ 813.2	\$ 327.4	\$ 1,481.6	\$ 1,023.6
Other comprehensive income, net:				
Net unrealized gains on available-for-sale securities	70.1	120.3	569.1	827.9
Noncredit component of impairment losses on fixed maturities, available-for-sale	13.3	(5.3)	21.0	(6.9)
Net unrealized gains (losses) on derivative instruments	(11.1)	3.7	(29.3)	16.2
Foreign currency translation adjustment	88.6	(16.0)	151.3	127.8
Net unrecognized postretirement benefit obligation	4.2	8.0	12.8	24.0
Other comprehensive income	165.1	110.7	724.9	989.0
Comprehensive income	978.3	438.1	2,206.5	2,012.6
Comprehensive income attributable to noncontrolling interest	5.0	18.8	15.7	30.5
Comprehensive income attributable to Principal Financial Group, Inc.	\$ 973.3	\$ 419.3	\$ 2,190.8	\$ 1,982.1

*See accompanying notes.*

Table of Contents**Principal Financial Group, Inc.****Consolidated Statements of Stockholders' Equity****(Unaudited)**

	<b>Common stock</b>	<b>Additional paid-in capital</b>	<b>Retained earnings</b>	<b>Accumulated other comprehensive income (loss)</b> <i>(in millions)</i>	<b>Treasury stock</b>	<b>Noncontrolling interest</b>	<b>Total stockholders equity</b>
<b>Balances as of January 1, 2016</b>	\$ 4.7	\$ 9,544.8	\$ 6,875.9	\$ (882.5)	\$ (6,231.3)	\$ 65.8	\$ 9,377.4
Common stock issued		25.7					25.7
Stock-based compensation and additional related tax benefits		65.0	(5.2)			0.3	60.1
Treasury stock acquired, common					(245.2)		(245.2)
Dividends to common stockholders			(341.1)				(341.1)
Distributions to noncontrolling interest						(3.7)	(3.7)
Contributions from noncontrolling interest						0.7	0.7
Purchase of subsidiary shares from noncontrolling interest (1)		15.1		(9.3)			5.8
Adjustments to redemption amount of redeemable noncontrolling interest		(4.1)					(4.1)
Net income (1)			998.5			4.3	1,002.8
Other comprehensive income (1)				983.6		1.8	985.4
<b>Balances as of September 30, 2016</b>	\$ 4.7	\$ 9,646.5	\$ 7,528.1	\$ 91.8	\$ (6,476.5)	\$ 69.2	\$ 10,863.8
<b>Balances as of January 1, 2017</b>	\$ 4.7	\$ 9,686.0	\$ 7,720.4	\$ (675.2)	\$ (6,508.6)	\$ 66.5	\$ 10,293.8
Common stock issued		143.1					143.1
Stock-based compensation		68.1	(5.9)			0.2	62.4
Treasury stock acquired, common					(218.1)		(218.1)
Dividends to common stockholders			(398.5)				(398.5)
Distributions to noncontrolling interest						(6.1)	(6.1)
Contributions from noncontrolling interest						4.2	4.2
Purchase of subsidiary shares from noncontrolling interest (1)		(7.6)				(1.3)	(8.9)
Adjustments to redemption amount of redeemable noncontrolling interest		(2.8)					(2.8)
Net income (1)			1,468.6			6.1	1,474.7
Other comprehensive income (1)				722.2		1.3	723.5
<b>Balances as of September 30, 2017</b>	\$ 4.7	\$ 9,886.8	\$ 8,784.6	\$ 47.0	\$ (6,726.7)	\$ 70.9	\$ 12,067.3

(1) Excludes amounts attributable to redeemable noncontrolling interest. See Note 9, Stockholders' Equity, for further details.

See accompanying notes.



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

	<b>For the nine months ended September 30,</b>	
	<b>2017</b>	<b>2016</b>
	<i>(in millions)</i>	
<b>Operating activities</b>		
Net income	\$ 1,481.6	\$ 1,023.6
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred acquisition costs	173.8	264.0
Additions to deferred acquisition costs	(307.2)	(293.6)
Accrued investment income	(54.0)	(67.8)
Net cash flows for trading securities	55.3	25.6
Premiums due and other receivables	(158.2)	68.9
Contractholder and policyholder liabilities and dividends	2,693.5	1,594.4
Current and deferred income taxes	456.0	75.6
Net realized capital gains	(564.1)	(214.5)
Depreciation and amortization expense	144.8	139.6
Real estate acquired through operating activities	(55.2)	(31.2)
Real estate sold through operating activities	1.3	21.4
Stock-based compensation	62.2	58.7
Other	(301.1)	262.6
Net adjustments	2,147.1	1,903.7
Net cash provided by operating activities	3,628.7	2,927.3
<b>Investing activities</b>		
Available-for-sale securities:		
Purchases	(10,425.7)	(10,590.0)
Sales	1,011.2	1,138.1
Maturities	6,577.2	5,836.0
Mortgage loans acquired or originated	(2,036.5)	(2,116.3)
Mortgage loans sold or repaid	1,297.4	1,440.8
Real estate acquired	(113.6)	(90.2)
Real estate sold	457.1	35.5
Net purchases of property and equipment	(133.3)	(109.1)
Net change in other investments	48.5	(42.4)
Net cash used in investing activities	(3,317.7)	(4,497.6)
<b>Financing activities</b>		
Issuance of common stock	143.1	25.7
Acquisition of treasury stock	(218.1)	(245.2)
Proceeds from financing element derivatives	0.1	0.3
Payments for financing element derivatives	(59.5)	(67.3)
Excess tax benefits from share-based payment arrangements		5.9
Purchase of subsidiary shares from noncontrolling interest	(13.3)	(2.4)
Dividends to common stockholders	(398.5)	(341.1)
Issuance of long-term debt		11.0
Principal repayments of long-term debt	(56.2)	
Net proceeds from (repayments of) short-term borrowings	4.9	(143.4)
Investment contract deposits	8,244.4	8,108.5
Investment contract withdrawals	(7,963.1)	(6,201.4)
Net increase in banking operation deposits	79.8	69.6

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

Other		<b>0.8</b>		3.5
Net cash provided by (used in) financing activities		<b>(235.6)</b>		1,223.7
Net increase (decrease) in cash and cash equivalents		<b>75.4</b>		(346.6)
Cash and cash equivalents at beginning of period		<b>2,719.6</b>		2,564.8
Cash and cash equivalents at end of period	\$	<b>2,795.0</b>	\$	2,218.2

**Supplemental disclosure of non-cash activities:**

Assets and liability changes resulting from exchange agreement to exit real estate joint ventures:

Real estate properties received	\$	<b>743.2</b>	\$	
Long-term debt assumed on real estate properties received	\$	<b>269.0</b>	\$	
Increase in other investments due to discontinuing equity method accounting	\$	<b>222.4</b>	\$	

*See accompanying notes.*

Table of Contents

**Principal Financial Group, Inc.  
Notes to Consolidated Financial Statements**

**September 30, 2017  
(Unaudited)**

**1. Nature of Operations and Significant Accounting Policies**

**Basis of Presentation**

The accompanying unaudited consolidated financial statements of Principal Financial Group, Inc. ( PFG ) have been prepared in conformity with accounting principles generally accepted in the U.S. ( U.S. GAAP ) for interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2017, are not necessarily indicative of the results that may be expected for the year ended December 31, 2017. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2016, included in our Form 10-K for the year ended December 31, 2016, filed with the United States Securities and Exchange Commission ( SEC ). The accompanying consolidated statement of financial position as of December 31, 2016, has been derived from the audited consolidated statement of financial position but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

**Consolidation**

We have relationships with various special purpose entities and other legal entities that must be evaluated to determine if the entities meet the criteria of a variable interest entity ( VIE ) or a voting interest entity ( VOE ). This assessment is performed by reviewing contractual, ownership and other rights, including involvement of related parties, and requires use of judgment. First, we determine if we hold a variable interest in an entity by assessing if we have the right to receive expected losses and expected residual returns of the entity. If we hold a variable interest, then the entity is assessed to determine if it is a VIE. An entity is a VIE if the equity at risk is not sufficient to support its activities, if the equity holders lack a controlling financial interest or if the entity is structured with non-substantive voting rights. In addition to the previous criteria, if the entity is a limited partnership or similar entity, it is a VIE if the limited partners do not have the power to direct the entity's most significant activities through substantive kick-out rights or participating rights. A VIE is evaluated to determine the primary beneficiary. The primary beneficiary of a VIE is 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. When we are the primary beneficiary, we are required to consolidate the entity in our financial statements. We reassess our involvement with VIEs on a quarterly basis. For further information about VIEs, refer to Note 2, Variable Interest Entities.

If an entity is not a VIE, it is considered a VOE. VOEs are generally consolidated if we own a greater than 50% voting interest. If we determine our involvement in an entity no longer meets the requirements for consolidation under either the VIE or VOE models, the entity is deconsolidated. Entities in which we have significant management influence over the operating and financing decisions but are not required to consolidate, other than investments accounted for at fair value under the fair value option, are reported using the equity method.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**Recent Accounting Pronouncements**

Description	Date of adoption	Effect on our consolidated financial statements or other significant matters
<i>Standards not yet adopted:</i>		
<p><b>Goodwill impairment testing</b>  This authoritative guidance simplifies how an entity is required to test goodwill for impairment by eliminating Step 2 (which measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill to the carrying amount of that goodwill) from the goodwill impairment test. A goodwill impairment loss will be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. Entities will continue to have the option to perform a qualitative assessment to determine if a quantitative impairment test is necessary. Early adoption is permitted.</p>	January 1, 2020	We are currently evaluating the impact this guidance will have on our consolidated financial statements.
<p><b>Credit losses</b>  This authoritative guidance requires entities to use a current expected credit loss ( CECL ) model to measure impairment for most financial assets that are not recorded at fair value through net income. Under the CECL model, an entity will estimate lifetime expected credit losses considering available relevant information about historical events, current conditions and reasonable and supportable forecasts. The CECL model does not apply to available-for-sale debt securities. This guidance also expands the required credit loss disclosures and will be applied using a modified retrospective approach by recording a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. Early adoption is permitted.</p>	January 1, 2020	We are currently evaluating the impact this guidance will have on our consolidated financial statements. We believe estimated credit losses under the CECL model will generally result in earlier loss recognition for loans and other receivables.
<p><b>Targeted improvements to accounting for hedging activities</b>  This authoritative guidance updates certain recognition and measurement requirements for hedge accounting. The objective of the guidance is to more closely align the economics of a company's risk management activities in its financial results and reduce the complexity of applying hedge accounting. The updates include the expansion of hedging</p>	January 1, 2019	We are currently evaluating the impact this guidance will have on our consolidated financial statements.

<p>strategies that are eligible for hedge accounting, elimination of the separate measurement and reporting of hedge ineffectiveness, presentation of the changes in the fair value of the hedging instrument in the same consolidated statement of operations line as the earnings effect of the hedged item and simplification of hedge effectiveness assessments. This guidance also includes new disclosures and will be applied using a modified retrospective approach by recording a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. Early adoption is permitted.</p>		
<p><b>Premium amortization on purchased callable debt securities</b>                  This authoritative guidance applies to entities that hold certain non-contingently callable debt securities, where the amortized cost basis is at a premium to the price repayable by the issuer at the earliest call date. Under the guidance the premium will be amortized to the first call date. This guidance requires adoption through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. Early adoption is permitted.</p>	<p>January 1, 2019</p>	<p>We are currently evaluating the impact this guidance will have on our consolidated financial statements.</p>

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

Description	Date of adoption	Effect on our consolidated financial statements or other significant matters
<p><b>Leases</b>  This authoritative guidance requires lessee recognition of lease assets and lease liabilities on the balance sheet. The concept of an operating lease, where the lease assets and liabilities are off balance sheet, is eliminated under the new guidance. For lessors, the guidance modifies lease classification criteria and accounting for certain types of leases. Other key aspects of the guidance relate to the removal of the current real estate-specific guidance and new presentation and disclosure requirements. Lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, which includes certain optional practical expedients that may be elected. Early adoption is permitted.</p>	January 1, 2019	We have primarily focused our implementation efforts on identifying our leases that are within the scope of the guidance and will be added to our balance sheet. We are currently evaluating other impacts this guidance will have on our consolidated financial statements.
<p><b>Nonfinancial asset derecognition and partial sales of nonfinancial assets</b>  This authoritative guidance clarifies the scope of the recently established guidance on nonfinancial asset derecognition and the accounting for partial sales of nonfinancial assets. The guidance conforms the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue recognition standard.</p>	January 1, 2018	We have nearly completed our evaluation of this guidance and do not expect it to have a material impact on our consolidated financial statements.
<p><b>Presentation of net periodic pension cost and net periodic postretirement benefit cost</b>  This authoritative guidance requires that an employer disaggregate the service cost component from the other components of net benefit cost. The guidance also provides explicit guidance on the presentation of the service cost component and the other components of net benefit cost in the consolidated statement of operations and allows only the service cost component of net benefit cost to be eligible for capitalization.</p>	January 1, 2018	This guidance is not expected to have a material impact on our consolidated financial statements.
<p><b>Definition of a business</b>  This authoritative guidance clarifies the definition of a business to assist with evaluating when transactions involving an integrated set of assets and activities (a set ) should be accounted for as acquisitions or disposals of assets or businesses. The guidance requires that when substantially all of the fair value of the gross assets acquired or disposed of is concentrated in a single identifiable asset or a group of similar identifiable assets, the</p>	January 1, 2018	We have nearly completed our evaluation of this guidance and do not expect it to have a material impact on our consolidated financial statements.

<p>set is not a business. The guidance also requires a set to include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output to be considered a business. Lastly, the guidance removes the evaluation of whether a market participant could replace missing elements and narrows the definition of outputs by more closely aligning it with how outputs are described in the revenue recognition guidance. The guidance will be applied prospectively. Early application is permitted in certain circumstances.</p>		
---	--	--



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

Description	Date of adoption	Effect on our consolidated financial statements or other significant matters
<p><b>Financial instruments - recognition and measurement</b></p> <p>This authoritative guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The primary focus of this guidance is to supersede the guidance to classify equity securities with readily determinable fair values into different categories (trading or available-for-sale) and rather requires these equity securities to be measured at fair value with changes in the fair value recognized through net income. This guidance requires adoption through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption.</p>	January 1, 2018	As of September 30, 2017, we did not hold material equity securities accounted for at fair value through other comprehensive income that will be accounted for at fair value through net income under the updated guidance. We have nearly completed our evaluation of this guidance and do not expect it to have a material impact on our consolidated financial statements.
<p><b>Revenue recognition</b></p> <p>This authoritative guidance replaces all general and most industry specific revenue recognition guidance currently prescribed by U.S. GAAP. The core principle is that an entity recognizes revenue to reflect the transfer of a promised good or service to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for that good or service. This guidance also provides clarification on when an entity is a principal or an agent in a transaction. In addition, the guidance updates the accounting for certain costs associated with obtaining and fulfilling a customer contract. The guidance may be applied using one of the following two methods: (1) retrospectively to each prior reporting period presented, or (2) retrospectively with the cumulative effect of initially applying the standard recognized at the date of initial application.</p>	January 1, 2018	Only a portion of our total revenues, less than 20%, are subject to this guidance as it does not apply to revenue on contracts accounted for under the insurance contracts or financial instruments standards. Our evaluation process is substantially complete and included, but was not limited to, identifying contracts within the scope of the guidance, reviewing and documenting our accounting for these contracts, identifying and determining the accounting for any related contract costs, and preparing the required financial statement disclosures. To date, we have identified financial statement changes related to deferring and amortizing certain sales compensation related to obtaining customer contracts, but we do not expect the impact of these changes to be material. We have not identified material changes in the timing of our revenue recognition. We plan to adopt the guidance on January 1, 2018, using the modified retrospective application.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

Description	Date of adoption	Effect on our consolidated financial statements or other significant matters
<p><b>Income tax - intra-entity transfers of assets</b>  This authoritative guidance requires entities to recognize current and deferred income tax resulting from an intra-entity asset transfer when the transfer occurs. Prior to issuance of this guidance, U.S. GAAP did not allow recognition of income tax consequences until the asset had been sold to a third party. This guidance requires adoption through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption with early adoption permitted.</p>	January 1, 2018	We have nearly completed our evaluation of this guidance and do not expect it to have a material impact on our consolidated financial statements.
<i>Standards adopted:</i>		
<p><b>Employee share-based payment accounting</b>  This authoritative guidance changes certain aspects of accounting for and reporting share-based payments to employees including changes related to the income tax effects of share-based payments, tax withholding requirements and accounting for forfeitures. Various transition methods will apply depending on the situation being addressed.</p>	January 1, 2017	The guidance was adopted prospectively as indicated by the guidance for each area of change and did not have a material impact on our consolidated financial statements.
<p><b>Short-duration insurance contracts</b>  This authoritative guidance requires additional disclosures related to short-duration insurance contracts.</p>	December 31, 2016	The disclosure requirements of this guidance were adopted retrospectively.
<p><b>Net asset value per share as a practical expedient for fair value</b>  This authoritative guidance removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient.</p>	January 1, 2016	The guidance was adopted retrospectively and did not have a material impact on our consolidated financial statements. See Note 10, Fair Value Measurements, for further details.
<p><b>Simplifying the presentation of debt issuance costs</b>  This authoritative guidance requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts.</p>	January 1, 2016	The guidance was adopted retrospectively and did not have a material impact on our consolidated financial statements.
<p><b>Consolidations</b>  This authoritative guidance makes changes to both the variable interest</p>	January 1, 2016	The guidance was adopted using the modified retrospective approach. See Note 2, Variable

and voting interest consolidation models and eliminates the investment company deferral for portions of the variable interest model. The amendments in the standard impact the consolidation analysis for interests in investment companies and limited partnerships and similar entities.

Interest Entities, for further details.

When we adopt new accounting standards, we have a process in place to perform a thorough review of the pronouncement, identify the financial statement and system impacts and create an implementation plan among our impacted business units to ensure we are compliant with the pronouncement on the date of adoption. This includes having effective processes and controls in place to support the reported amounts. Each of the standards listed above is in varying stages in our implementation process based on its issuance and adoption dates. We are on track to implement guidance by the respective effective dates.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**Derivatives**

*Over-The-Counter Derivatives Cleared on Chicago Mercantile Exchange*

We use certain over-the-counter ( OTC ) interest rate contracts that are subject to derivative clearing agreements. These agreements require the daily cash settlement of variation margin based on changes in the fair value of the derivative instrument. Prior to 2017, variation margin for all such interest rate contracts was treated as collateral, which was accounted for separately as an interest-bearing asset or liability. For reporting purposes, we did not offset fair value amounts recognized for the right to reclaim variation margin collateral or the obligation to return variation margin collateral against fair value amounts recognized for derivative instruments executed with the same counterparties under master netting agreements.

Effective January 2017, the Chicago Mercantile Exchange ( CME ) rulebook was amended to legally characterize variation margin payments for cleared OTC derivatives as settlements of the derivative exposure rather than collateral against the derivative exposure. The economic cash flows exchanged do not change and therefore hedge accounting is unchanged; however, the variation margin and derivative instrument are considered a single unit of account for accounting and presentation purposes. As settlements, variation margin receipts and payments are considered cash flows of the derivative and reduce the recognized asset or liability arising from the derivative's mark-to-market for balance sheet presentation, effectively resulting in the derivative having a fair value that approximates zero. As of December 31, 2016, our consolidated statements of financial position included \$528.0 million in other investments and \$527.7 million in other liabilities related to OTC interest rate contracts cleared with the CME. The balance of those line items was reduced by those amounts in January 2017 as a result of the CME rulebook amendment. The rulebook amendment did not have an impact on net income. Additionally, the change by the CME did not impact the accounting for our OTC derivatives not cleared with the CME.

**Separate Accounts**

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

Separate account assets and separate account liabilities include certain international retirement accumulation products where the segregated funds and associated obligation to the client are consolidated within our financial statements. We have determined that summary totals are the

most meaningful presentation for these funds.

As of September 30, 2017 and December 31, 2016, the separate accounts included a separate account valued at \$162.9 million and \$158.4 million, respectively, which primarily included shares of our stock that were allocated and issued to eligible participants of qualified employee benefit plans administered by us as part of the policy credits issued under our 2001 demutualization. These shares are included in both basic and diluted earnings per share calculations. In the consolidated statements of financial position, the separate account shares are recorded at fair value and are reported as separate account assets with a corresponding separate account liability to eligible participants of the qualified plan. Changes in fair value of the separate account shares are reflected in both the separate account assets and separate account liabilities and do not impact our results of operations.

## **2. Variable Interest Entities**

We have relationships with various types of entities which may be VIEs. Certain VIEs are consolidated in our financial results. See Note 1, Nature of Operations and Significant Accounting Policies, under the caption Consolidation for further details of our consolidation accounting policies. We did not provide financial or other support to investees designated as VIEs for the periods ended September 30, 2017 and December 31, 2016.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**Consolidated Variable Interest Entities**

*Grantor Trusts*

We contributed undated subordinated floating rate notes to three grantor trusts. The trusts separated their 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 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 significant continuing interest in the trusts.

*Collateralized Private Investment Vehicles*

We invest in synthetic and cash collateralized debt obligations, collateralized bond obligations, collateralized loan obligations and other collateralized structures, which are VIEs due to insufficient equity to sustain the entities (collectively known as collateralized private investment vehicles). The performance of the notes of these synthetic 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 and the notes due at maturity or termination of the trusts. We determined we were the primary beneficiary for one of these synthetic entities because we acted as the investment manager of the underlying portfolio and we had the power to make decisions and to receive benefits and the obligation to absorb losses that could be potentially significant to the VIE. This synthetic entity matured in the first quarter of 2017.

*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 determined we are the primary beneficiary as we retained the special servicing role for the assets within the trust as well as the ownership of the bond class that controls the unilateral kick-out rights of the special servicer.

*Mandatory Retirement Savings Funds*

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

Principal International Hong Kong offers retirement pension schemes in which we provide trustee, administration and asset management services to employers and employees under the Hong Kong Mandatory Provident Fund ( MPF ) and Occupational Retirement Schemes Ordinance ( ORSO ) pension schemes. Each pension scheme has various guaranteed and non-guaranteed constituent funds, or investment options, in which customers can invest their money. The guaranteed funds provide either a guaranteed rate of return to the customer or a minimum guarantee on withdrawals under certain qualifying events. We determined the guaranteed funds are VIEs due to the fact the equity holders, as a group, lack the obligation to absorb expected losses due to the guarantee we provide. We concluded we are the primary beneficiary because we have the power to make decisions and to receive benefits and the obligation to absorb losses that could be potentially significant to the VIE. Therefore, we consolidate the underlying assets and liabilities of the funds and present as separate accounts or within the general account, depending on the terms of the guarantee.



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

***Real Estate***

We invest in several real estate limited partnerships and limited liability companies. The entities invest in real estate properties. Certain of these entities are VIEs based on the combination of our significant economic interest and related voting rights. We determined we are the primary beneficiary as a result of our power to control the entities through our significant ownership. Due to the nature of these real estate investments, the investment balance will fluctuate as we purchase and sell interests in the entities and as capital expenditures are made to improve the underlying real estate.

***Sponsored Investment Funds***

We sponsor and invest in certain investment funds for which we provide asset management services. Although our asset management fee is commensurate with the services provided and consistent with fees for similar services negotiated at arms-length, we have a variable interest for funds where our other interests are more than insignificant. The funds are VIEs as the equity holders lack power through voting rights to direct the activities of the entity that most significantly impact its economic performance. We determined we are the primary beneficiary of the VIEs where our interest in the entity is more than insignificant and we are the asset manager.

***Assets and Liabilities of Consolidated Variable Interest Entities***

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 were as follows:

	September 30, 2017		December 31, 2016	
	Total assets	Total liabilities	Total assets	Total liabilities
		<i>(in millions)</i>		
Grantor trusts (1)	\$ 258.2	\$ 242.5	\$ 233.3	\$ 212.3
Collateralized private investment vehicle (2)			82.4	61.5
CMBS	10.1		12.5	
Mandatory retirement savings funds (3)	40,473.3	40,099.7	36,526.7	36,202.8
Real estate (4)	318.6	14.2	329.2	26.8
Sponsored investment funds (5)	144.2	1.7	114.3	0.9
Total	\$ 41,204.4	\$ 40,358.1	\$ 37,298.4	\$ 36,504.3

- (1) The assets of grantor trusts are primarily fixed maturities, available-for-sale. The liabilities are primarily other liabilities that reflect an embedded derivative of the forecasted transaction to deliver the underlying securities.
- (2) The assets of the collateralized private investment vehicle were primarily fixed maturities, trading. The liabilities included derivative liabilities and an obligation to redeem notes at maturity or termination of the trusts, which were reported in other liabilities.
- (3) The assets of the mandatory retirement savings funds include separate account assets and equity securities, trading. The liabilities include separate account liabilities and contractholder funds.
- (4) The assets of the real estate VIEs primarily include real estate, other investments and cash. Liabilities primarily include other liabilities.
- (5) The assets of sponsored investment funds are primarily fixed maturities and equity securities, which are reported in other investments, and cash. The consolidated statements of financial position included a \$50.1 million and \$58.8 million redeemable noncontrolling interest for sponsored investment funds as of September 30, 2017 and December 31, 2016, respectively.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**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; equity securities, trading and other investments in the consolidated statements of financial position and are described below.

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

As previously discussed, we invest in several types of collateralized private investment vehicles that are VIEs. These include synthetic and cash 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 and similar entities as a debt holder. Most of these entities are classified as VIEs due to insufficient equity to sustain them. In addition, we have an entity classified as a VIE based on the combination of our significant economic interest and lack of voting rights. 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 and other funds, which are classified as VIEs. The entities are VIEs as equity holders lack the power to control the most significant activities of the entities because the equity holders do not have either the ability by a simple majority to exercise substantive kick-out rights or substantive participating rights. We have determined we are not the primary beneficiary because we do not have the power to direct the most significant activities of the entities.

As previously discussed, we sponsor and invest in certain investment funds that are VIEs. We determined we are not the primary beneficiary of the VIEs for which we are the asset manager but do not have a potentially significant variable interest in the funds.

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

We hold an equity interest in Mexican mandatory privatized social security funds in which we provide asset management services. Our equity interest in the funds is considered a variable interest. We concluded the funds are VIEs because the equity holders as a group lack decision-making ability through their voting rights. We are not the primary beneficiary of the VIEs because although we, as the asset manager, have the power to direct the activities of the VIEs, we do not have a potentially significant variable interest in the funds.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	Asset carrying value	(in millions)	Maximum exposure to loss (1)
<b>September 30, 2017</b>			
Fixed maturities, available-for-sale:			
Corporate	\$	405.1	\$ 337.3
Residential mortgage-backed pass-through securities		2,637.9	2,591.0
Commercial mortgage-backed securities		3,749.5	3,761.3
Collateralized debt obligations		1,239.2	1,249.3
Other debt obligations		5,375.9	5,351.2
Fixed maturities, trading:			
Residential mortgage-backed pass-through securities		15.9	15.9
Commercial mortgage-backed securities		0.7	0.7
Equity securities, trading		82.3	82.3
Other investments:			
Other limited partnership and fund interests		743.7	1,325.7
<b>December 31, 2016</b>			
Fixed maturities, available-for-sale:			
Corporate	\$	368.4	\$ 298.6
Residential mortgage-backed pass-through securities		2,834.7	2,798.0
Commercial mortgage-backed securities		4,096.5	4,153.2
Collateralized debt obligations		758.6	780.1
Other debt obligations		5,036.1	5,048.9
Fixed maturities, trading:			
Residential mortgage-backed pass-through securities		19.9	19.9
Commercial mortgage-backed securities		1.9	1.9
Collateralized debt obligations		10.6	10.6
Equity securities, trading		68.3	68.3
Other investments:			
Other limited partnership and fund interests		654.6	1,127.8

(1) Our risk of loss is limited to our initial investment measured at amortized cost for fixed maturities, available-for-sale. Our risk of loss is limited to our investment measured at fair value for our fixed maturities, trading and equity securities, trading. Our risk of loss is limited to our carrying value plus any unfunded commitments and/or guarantees for our other investments. Unfunded commitments are not liabilities on our consolidated statements of financial position because we are only required to fund additional equity when called upon to do so by the general partner or investment manager.

*Money Market Fund*

We are the investment manager for a money market mutual fund. This type of fund is exempt from assessment under any consolidation model due to a scope exception for money market funds registered under Rule 2a-7 of the Investment Company Act of 1940 or similar funds. As of September 30, 2017 and December 31, 2016, the fund we manage held \$0.7 billion and \$0.8 billion in total assets, respectively. We have no contractual obligation to contribute to the fund; however, we provide support through the waiver of fees and through expense reimbursements. The amount of fees waived and expenses reimbursed was insignificant.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**3. Investments****Fixed Maturities and Equity Securities**

Fixed maturities include bonds, ABS, redeemable preferred stock and certain non-redeemable preferred securities. Equity securities include mutual funds, common stock, non-redeemable preferred stock and required regulatory investments. We classify fixed maturities and equity securities as either available-for-sale or trading at the time of the purchase and, accordingly, carry them at fair value. See Note 10, 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 associated with deferred acquisition costs ( DAC ) and related actuarial balances, 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). Mark-to-market adjustments related to certain securities carried at fair value with an investment objective to realize economic value through mark-to-market changes are reflected in net investment income.

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

The amortized cost, gross unrealized gains and losses, other-than-temporary impairments in accumulated other comprehensive income ( AOCI ) and fair value of fixed maturities and equity securities available-for-sale were as follows:

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value	Other-than- temporary impairments in AOCI (1)
<i>(in millions)</i>					
<b>September 30, 2017</b>					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 1,427.3	\$ 37.4	\$ 7.0	\$ 1,457.7	\$
Non-U.S. governments	932.0	141.3	2.0	1,071.3	

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

States and political subdivisions	6,354.6	322.8	21.8	6,655.6	
Corporate	34,660.1	2,357.1	128.9	36,888.3	9.4
Residential mortgage-backed pass-through securities	2,591.0	63.7	16.8	2,637.9	
Commercial mortgage-backed securities	3,761.3	34.0	45.8	3,749.5	58.5
Collateralized debt obligations	1,249.3	3.2	13.3	1,239.2	0.3
Other debt obligations	5,413.1	50.9	25.7	5,438.3	45.7
Total fixed maturities, available-for-sale	\$ 56,388.7	\$ 3,010.4	\$ 261.3	\$ 59,137.8	\$ 113.9
Total equity securities, available-for-sale	\$ 117.4	\$ 7.2	\$ 6.3	\$ 118.3	
<b>December 31, 2016</b>					
Fixed maturities, available-for-sale:					
U.S. government and agencies	\$ 1,426.7	\$ 17.2	\$ 10.9	\$ 1,433.0	\$
Non-U.S. governments	781.7	119.3	7.4	893.6	
States and political subdivisions	5,463.9	192.4	87.1	5,569.2	1.1
Corporate	32,699.7	1,843.5	350.8	34,192.4	17.2
Residential mortgage-backed pass-through securities	2,798.0	67.3	30.6	2,834.7	
Commercial mortgage-backed securities	4,153.2	31.2	87.9	4,096.5	77.5
Collateralized debt obligations	780.1	2.8	24.3	758.6	0.3
Other debt obligations	5,080.9	37.0	49.8	5,068.1	50.3
Total fixed maturities, available-for-sale	\$ 53,184.2	\$ 2,310.7	\$ 648.8	\$ 54,846.1	\$ 146.4
Total equity securities, available-for-sale	\$ 104.9	\$ 4.9	\$ 10.9	\$ 98.9	



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

(1) Excludes \$120.1 million and \$120.9 million as of September 30, 2017 and December 31, 2016, respectively, of net unrealized gains on impaired fixed maturities, available-for-sale related to changes in fair value subsequent to the impairment date, which are included in gross unrealized gains and gross unrealized losses.

The amortized cost and fair value of fixed maturities available-for-sale as of September 30, 2017, by expected maturity, were as follows:

	Amortized cost		Fair value
	<i>(in millions)</i>		
Due in one year or less	\$	2,986.9	\$ 3,010.1
Due after one year through five years		11,894.1	12,308.5
Due after five years through ten years		9,865.0	10,256.6
Due after ten years		18,628.0	20,497.7
Subtotal		43,374.0	46,072.9
Mortgage-backed and other asset-backed securities		13,014.7	13,064.9
Total	\$	56,388.7	\$ 59,137.8

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

**Net Realized Capital Gains and Losses**

Net realized capital gains and losses on sales of investments are determined on the basis of specific identification. In 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 sponsored investment funds, 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, impairments of real estate held for investment and impairments on equity method investments. Investment gains and losses on sales of certain real estate held for sale due to investment strategy and mark-to-market adjustments on certain securities carried at fair value with an investment objective to realize economic value through mark-to-market changes are reported as net investment income and are excluded from net realized capital gains (losses). The major components of net realized capital gains (losses) on investments were as follows:

For the three months ended

For the nine months ended

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

	September 30,		September 30,	
	2017	2016	2017	2016
	<i>(in millions)</i>			
Fixed maturities, available-for-sale:				
Gross gains	\$ 2.1	\$ 15.3	\$ 12.3	\$ 65.4
Gross losses	(1.6)	(3.1)	(17.1)	(6.6)
Net impairment losses	(16.6)	(11.0)	(59.6)	(67.7)
Hedging, net	(1.2)	(9.1)	(17.2)	(2.7)
Fixed maturities, trading	(3.0)	5.6	(1.2)	15.7
Equity securities, available-for-sale:				
Net impairment losses		(0.3)		(1.7)
Equity securities, trading	14.8	21.6	51.2	17.4
Mortgage loans	1.2	1.4	0.9	4.0
Derivatives	(38.1)	(4.9)	(148.4)	152.8
Other (1)	719.0	28.7	743.2	37.9
Net realized capital gains	\$ 676.6	\$ 44.2	\$ 564.1	\$ 214.5

(1) See Note 3, Investments - Real Estate Transactions, for further details.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

Proceeds from sales of investments (excluding call and maturity proceeds) in fixed maturities, available-for-sale were \$163.2 million and \$490.4 million for the three months ended September 30, 2017 and 2016, and \$968.6 million and \$1,150.8 million for the nine months ended September 30, 2017 and 2016, respectively.

**Other-Than-Temporary Impairments**

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

Each reporting period, all securities are reviewed to determine whether an other-than-temporary decline in value exists and whether losses should be recognized. We consider relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events; (4) for structured securities, the adequacy of the expected cash flows; (5) for fixed maturities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and (6) for equity securities, our ability and intent to hold the security for a period of time that allows for the recovery in value. To the extent we determine 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 three months ended September 30,		For the nine months ended September 30,	
2017	2016	2017	2016

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

			<i>(in millions)</i>					
Fixed maturities, available-for-sale	\$	2.6	\$	(21.7)	\$	(27.1)	\$	(79.3)
Equity securities, available-for-sale				(0.3)				(1.7)
Total other-than-temporary impairment losses, net of recoveries from the sale of previously impaired securities		2.6		(22.0)		(27.1)		(81.0)
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) OCI (1)		(19.2)		10.7		(32.5)		11.6
Net impairment losses on available-for-sale securities	\$	(16.6)	\$	(11.3)	\$	(59.6)	\$	(69.4)

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

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2017	2016	2017	2016
	<i>(in millions)</i>			
Beginning balance	\$ (154.8)	\$ (155.8)	\$ (139.9)	\$ (131.5)
Credit losses for which an other-than-temporary impairment was not previously recognized		(5.7)	(14.4)	(32.7)
Credit losses for which an other-than-temporary impairment was previously recognized	(6.5)	(5.2)	(28.7)	(19.3)
Reduction for credit losses previously recognized on fixed maturities now sold, paid down or intended to be sold	33.6	11.5	50.9	28.3
Net reduction for positive changes in cash flows expected to be collected and amortization (1)	3.3	2.4	7.8	2.6
Foreign currency translation adjustment		(0.1)	(0.1)	(0.3)
Ending balance	\$ (124.4)	\$ (152.9)	\$ (124.4)	\$ (152.9)

(1) Amounts are recognized in net investment income.

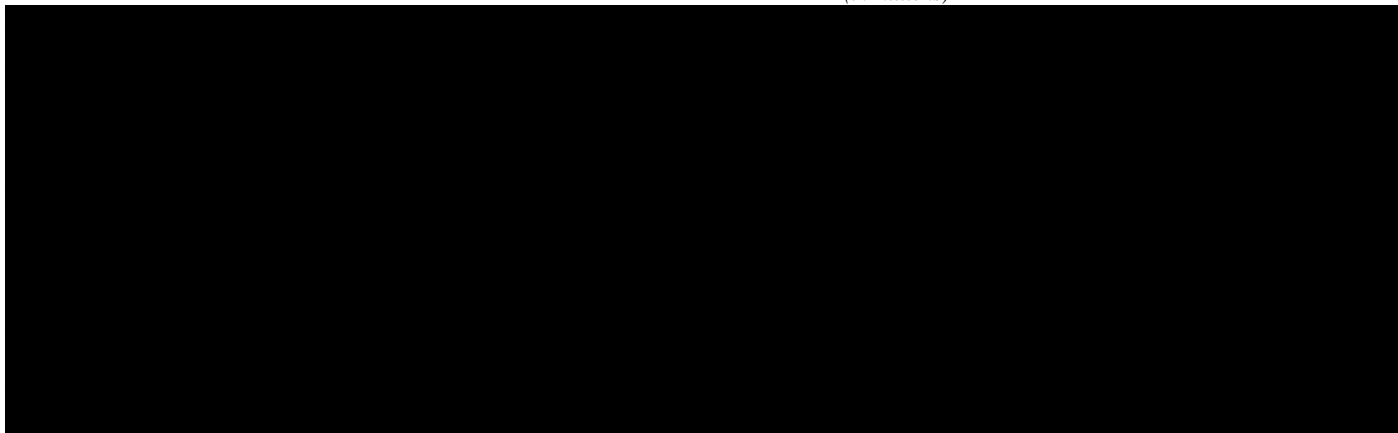
Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**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 were as follows:

Less than twelve months		September 30, 2017 Greater than or equal to twelve months		Total	
Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses
<i>(in millions)</i>					



Of the total amounts, Principal Life Insurance Company's (Principal Life's) consolidated portfolio represented \$11,507.4 million in available-for-sale fixed maturities with gross unrealized losses of \$246.0 million. Of those fixed maturity securities in Principal Life's consolidated portfolio with a gross unrealized loss position, 96% were investment grade (rated AAA through BBB-) with an average price of 98 (carrying value/amortized cost) as of September 30, 2017. Gross unrealized losses in our fixed maturities portfolio decreased during the nine months ended September 30, 2017, primarily due to tightening of credit spreads and a decrease in interest rates.

For those securities that had been in a continuous unrealized loss position for less than twelve months, Principal Life's consolidated portfolio held 1,061 securities with a carrying value of \$8,037.0 million and unrealized losses of \$83.8 million reflecting an average price of 99 as of September 30, 2017. Of this portfolio, 99% was investment grade (rated AAA through BBB-) as of September 30, 2017, with associated unrealized losses of \$81.8 million. The unrealized losses on these securities can

primarily be attributed to changes in market interest rates and changes in credit spreads since the securities were acquired.

For those securities that had been in a continuous unrealized loss position greater than or equal to twelve months, Principal Life's consolidated portfolio held 600 securities with a carrying value of \$3,470.4 million and unrealized losses of \$162.2 million. The average credit rating of this portfolio was A+ with an average price of 96 as of September 30, 2017. Of the \$162.2 million in unrealized losses, the corporate sector accounts for \$72.3 million in unrealized losses with an average price of 95 and an average credit rating of BBB+. The remaining unrealized losses also include \$34.1 million within the commercial mortgage-backed securities sector with an average price of 96 and an average credit rating of AA+. 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 as of September 30, 2017.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

	Less than twelve months		December 31, 2016 Greater than or equal to twelve months		Total	
	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses
	<i>(in millions)</i>					
Fixed maturities, available-for-sale:						
U.S. government and agencies	\$ 570.3	\$ 10.9	\$ 8.2	\$ 2.0	\$ 578.5	\$ 10.9
Non-U.S. governments	198.0	5.4	12.2	2.0	210.2	7.4
States and political subdivisions	2,229.4	86.6	4.8	0.5	2,234.2	87.1
Corporate	6,559.7	189.2	1,285.6	161.6	7,845.3	350.8
Residential mortgage-backed pass-through securities	1,265.6	29.8	16.0	0.8	1,281.6	30.6
Commercial mortgage-backed securities	1,637.2	41.0	612.5	46.9	2,249.7	87.9
Collateralized debt obligations	265.7	0.9	195.6	23.4	461.3	24.3
Other debt obligations	2,229.4	32.8	376.2	17.0	2,605.6	49.8
Total fixed maturities, available-for-sale	\$ 14,955.3	\$ 396.6	\$ 2,511.1	\$ 252.2	\$ 17,466.4	\$ 648.8
Total equity securities, available-for-sale	\$ 18.2	\$ 0.4	\$ 35.4	\$ 10.5	\$ 53.6	\$ 10.9

Of the total amounts, Principal Life's consolidated portfolio represented \$16,918.9 million in available-for-sale fixed maturities with gross unrealized losses of \$615.1 million. Of those fixed maturity securities in Principal Life's consolidated portfolio with a gross unrealized loss position, 94% were investment grade (rated AAA through BBB-) with an average price of 96 (carrying value/amortized cost) as of December 31, 2016. Gross unrealized losses in our fixed maturities portfolio decreased during the year ended December 31, 2016, primarily due to tightening of credit spreads, partially offset by an increase in interest rates.

For those securities that had been in a continuous unrealized loss position for less than twelve months, Principal Life's consolidated portfolio held 1,911 securities with a carrying value of \$14,549.4 million and unrealized losses of \$384.6 million reflecting an average price of 97 as of December 31, 2016. Of this portfolio, 98% was investment grade (rated AAA through BBB-) as of December 31, 2016, with associated unrealized losses of \$374.1 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 453 securities with a carrying value of \$2,369.5 million and unrealized losses of \$230.5 million. The average credit rating of this portfolio was A- with an average price of 91 as of December 31, 2016. Of the \$230.5 million in unrealized losses, the corporate sector accounts for \$141.9 million in unrealized losses with an average



price of 89 and an average credit rating of BBB-. The remaining unrealized losses consist primarily of \$46.9 million within the commercial mortgage-backed securities sector with an average price of 93 and an average credit rating of AA-. 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 as of December 31, 2016.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

The net unrealized gains and losses on investments in available-for-sale securities, the noncredit component of impairment losses on fixed maturities available-for-sale and the net unrealized gains and losses on derivative instruments in cash flow hedge relationships are reported as separate components of stockholders' equity. The cumulative amount of net unrealized gains and losses on available-for-sale securities and derivative instruments in cash flow hedge relationships net of adjustments related to DAC and related actuarial balances and applicable income taxes was as follows:

	September 30, 2017		December 31, 2016
	<i>(in millions)</i>		
Net unrealized gains on fixed maturities, available-for-sale (1)	\$ 2,830.4	\$	1,727.8
Noncredit component of impairment losses on fixed maturities, available-for-sale	(113.9)		(146.4)
Net unrealized gains (losses) on equity securities, available-for-sale	0.9		(6.0)
Adjustments for assumed changes in amortization patterns	(169.8)		(121.9)
Adjustments for assumed changes in policyholder liabilities	(630.7)		(469.2)
Net unrealized gains on derivative instruments	133.0		186.5
Net unrealized gains on equity method subsidiaries and noncontrolling interest adjustments	52.6		68.0
Provision for deferred income taxes	(714.7)		(411.8)
Net unrealized gains on available-for-sale securities and derivative instruments	\$ 1,387.8	\$	827.0

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

**Mortgage Loans**

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

September 30, 2017                      December 31, 2016  
*(in millions)*

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

Commercial mortgage loans	\$	<b>12,773.5</b>	\$	12,055.2
Residential mortgage loans		<b>1,290.6</b>		1,219.9
Total amortized cost		<b>14,064.1</b>		13,275.1
Valuation allowance		<b>(43.7)</b>		(44.9)
Total carrying value	\$	<b>14,020.4</b>	\$	13,230.2

We periodically purchase mortgage loans as well as sell mortgage loans we have originated. Mortgage loans purchased and sold were as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2017	2016	2017	2016
	<i>(in millions)</i>			
Commercial mortgage loans:				
Purchased	\$ 41.2	\$ 25.8	\$ 97.2	\$ 122.8
Sold				0.3
Residential mortgage loans:				
Purchased	68.4	88.8	222.8	212.7
Sold	17.5	11.0	47.9	39.9

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	September 30, 2017			December 31, 2016	
	Amortized cost	Percent of total		Amortized cost	Percent of total
	(\$ in millions)				
<b>Geographic distribution</b>					
New England	\$ 601.6	4.7 %	\$	532.1	4.4%
Middle Atlantic	3,697.0	29.0		3,317.3	27.5
East North Central	714.7	5.6		652.6	5.4
West North Central	176.3	1.4		185.6	1.5
South Atlantic	2,287.2	17.9		2,189.5	18.2
East South Central	371.8	2.9		239.3	2.0
West South Central	1,111.1	8.7		1,211.7	10.1
Mountain	919.7	7.2		932.6	7.7
Pacific	2,748.0	21.5		2,707.2	22.5
International	146.1	1.1		87.3	0.7
Total	\$ 12,773.5	100.0%	\$	12,055.2	100.0%
<b>Property type distribution</b>					
Office	\$ 4,543.5	35.6%	\$	4,417.6	36.6%
Retail	2,719.0	21.3		2,671.1	22.2
Industrial	1,943.6	15.2		1,802.4	15.0
Apartments	3,168.9	24.8		2,741.4	22.7
Hotel	152.4	1.2		260.7	2.2
Mixed use/other	246.1	1.9		162.0	1.3
Total	\$ 12,773.5	100.0%	\$	12,055.2	100.0%

Our residential mortgage loan portfolio is composed of home equity mortgages with an amortized cost of \$125.7 million and \$165.6 million and first lien mortgages with an amortized cost of \$1,164.9 million and \$1,054.3 million as of September 30, 2017 and December 31, 2016, respectively. Our residential home equity mortgages are concentrated in the United States and are generally second lien mortgages comprised of closed-end loans and lines of credit. Our first lien loans are concentrated in Chile and the United States.

**Mortgage Loan Credit Monitoring***Commercial Credit Risk Profile Based on Internal Rating*

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

We actively monitor and manage our commercial mortgage loan portfolio. All commercial mortgage loans are analyzed regularly and substantially all are internally rated, based on a proprietary risk rating cash flow model, in order to monitor the financial quality of these assets. The model stresses expected cash flows at various levels and at different points in time depending on the durability of the income stream, which includes our assessment of factors such as location (macro and micro markets), tenant quality and lease expirations. Our internal rating analysis presents expected losses in terms of an S&P Global ( S&P ) bond equivalent rating. As the credit risk for commercial mortgage loans increases, we adjust our internal ratings downward with loans in the category B+ and below having the highest risk for credit loss. Internal ratings on commercial mortgage loans are updated at least annually and potentially more often for certain loans with material changes in collateral value or occupancy and for loans on an internal watch list .

Commercial mortgage loans that require more frequent and detailed attention than other loans in our portfolio are identified and placed on an internal watch list . Among the criteria that would indicate a potential problem are significant negative changes in ratios of loan to value or contract rents to debt service, major tenant vacancies or bankruptcies, borrower sponsorship problems, late payments, delinquent taxes and loan relief/restructuring requests.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

The amortized cost of our commercial mortgage loan portfolio by credit risk, as determined by our internal rating system expressed in terms of an S&P bond equivalent rating, was as follows:

	<b>September 30, 2017</b>			
	<b>Brick and mortar</b>	<b>CTL</b>		<b>Total</b>
		<i>(in millions)</i>		
A- and above	\$ 11,414.2	\$ 150.2	\$	11,564.4
BBB+ thru BBB-	887.7	87.9		975.6
BB+ thru BB-	162.9			162.9
B+ and below	70.2	0.4		70.6
Total	\$ 12,535.0	\$ 238.5	\$	12,773.5

	<b>December 31, 2016</b>			
	<b>Brick and mortar</b>	<b>CTL</b>		<b>Total</b>
		<i>(in millions)</i>		
A- and above	\$ 10,612.8	\$ 158.5	\$	10,771.3
BBB+ thru BBB-	1,009.8	100.6		1,110.4
BB+ thru BB-	160.5			160.5
B+ and below	12.1	0.9		13.0
Total	\$ 11,795.2	\$ 260.0	\$	12,055.2

**Residential Credit Risk Profile Based on Performance Status**

Our residential mortgage loan portfolio is monitored based on performance of the loans. Monitoring on a residential mortgage loan increases when the loan is delinquent or earlier if there is an indication of potential impairment. We define non-performing residential mortgage loans as loans 90 days or greater delinquent or on non-accrual status.

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

	<b>September 30, 2017</b>			
	<b>Home equity</b>	<b>First liens</b>		<b>Total</b>
		<i>(in millions)</i>		
Performing	\$ 118.8	\$ 1,150.9	\$	1,269.7
Non-performing	6.9	14.0		20.9
Total	\$ 125.7	\$ 1,164.9	\$	1,290.6

**December 31, 2016**

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

	Home equity		First liens <i>(in millions)</i>		Total
Performing	\$ 156.8	\$	1,043.1	\$	1,199.9
Non-performing	8.8		11.2		20.0
Total	\$ 165.6	\$	1,054.3	\$	1,219.9

**Non-Accrual Mortgage Loans**

Commercial and residential mortgage loans are placed on non-accrual status if we have concern regarding the collectability of future payments or if a loan has matured without being paid off or extended. Factors considered may include conversations with the borrower, loss of major tenant, bankruptcy of borrower or major tenant, decreased property cash flow for commercial mortgage loans or number of days past due and other circumstances for residential mortgage loans. Based on an assessment as to the collectability of the principal, a determination is made to apply any payments received either against the principal or according to the contractual terms of the loan. When a loan is placed on non-accrual status, the accrued unpaid interest receivable is reversed against interest income. Accrual of interest resumes after factors resulting in doubts about collectability have improved. Residential first lien mortgages in the Chilean market are carried on accrual for a longer period of delinquency than domestic loans, as assessment of collectability is based on the nature of the loans and collection practices in that market.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	September 30, 2017	December 31, 2016
	<i>(in millions)</i>	
Commercial:		
Brick and mortar	\$ 64.1	\$
Residential:		
Home equity	6.9	8.8
First liens	3.8	5.6
Total	\$ 74.8	\$ 14.4

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

	September 30, 2017					Current	Total loans	Recorded investment 90 days or more and accruing
	30-59 days past due	60-89 days past due	90 days or more past due	Total past due				
	<i>(in millions)</i>							
Commercial-brick and mortar	\$	\$	\$	\$	\$	12,535.0	12,535.0	\$
Commercial-CTL						238.5	238.5	
Residential-home equity	1.3	0.6	0.8	2.7	123.0	125.7		
Residential-first liens	51.2	5.8	13.1	70.1	1,094.8	1,164.9	10.2	
Total	\$ 52.5	\$ 6.4	\$ 13.9	\$ 72.8	\$ 13,991.3	\$ 14,064.1	\$ 10.2	
	December 31, 2016					Current	Total loans	Recorded investment 90 days or more and accruing
	30-59 days past due	60-89 days past due	90 days or more past due	Total past due				
	<i>(in millions)</i>							
Commercial-brick and mortar	\$	\$	\$	\$	\$	11,795.2	11,795.2	\$
Commercial-CTL						260.0	260.0	
Residential-home equity	1.9	1.1	1.4	4.4	161.2	165.6		
Residential-first liens	40.1	11.3	10.0	61.4	992.9	1,054.3	5.6	
Total	\$ 42.0	\$ 12.4	\$ 11.4	\$ 65.8	\$ 13,209.3	\$ 13,275.1	\$ 5.6	



**Mortgage Loan Valuation Allowance**

We establish a valuation allowance to provide for the risk of credit losses inherent in our portfolio. The valuation allowance includes loan specific reserves for loans that are deemed to be impaired as well as reserves for pools of loans with similar risk characteristics where a property risk or market specific risk has not been identified but for which we anticipate a loss may occur. Mortgage loans on real estate are considered impaired when, based on current information and events, it is probable we will be unable to collect all amounts due according to contractual terms of the loan agreement. When we determine a loan is impaired, a valuation allowance is established equal to the difference between the carrying amount of the mortgage loan and the estimated value reduced by the cost to sell. Estimated value is based on either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or fair value of the collateral. Subsequent changes in the estimated value are reflected in the valuation allowance. Amounts on loans deemed to be uncollectible are charged off and removed from the valuation allowance. The change in the valuation allowance provision is included in net realized capital gains (losses) on our consolidated statements of operations.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

The valuation allowance is maintained at a level believed adequate by management to absorb estimated probable credit losses. Management's periodic evaluation and assessment of the valuation allowance adequacy is based on known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay, the estimated value of the underlying collateral, composition of the loan portfolio, portfolio delinquency information, underwriting standards, peer group information, current economic conditions, loss experience and other relevant factors. The evaluation of our impaired loan component is subjective, as it requires the estimation of timing and amount of future cash flows expected to be received on impaired loans.

We review our commercial mortgage loan portfolio and analyze the need for a valuation allowance for any loan that is delinquent for 60 days or more, in process of foreclosure, restructured, on the internal watch list or that currently has a valuation allowance. In addition to establishing allowance levels for specifically identified impaired commercial mortgage loans, management determines an allowance for all other loans in the portfolio for which historical experience and current economic conditions indicate certain losses exist. These loans are segregated by risk rating level with an estimated loss ratio applied against each risk rating level. The loss ratio is generally based upon historical loss experience for each risk rating level as adjusted for certain current environmental factors management believes to be relevant.

For our residential mortgage loan portfolio, we separate the loans into several homogeneous pools, each of which consist of loans of a similar nature including but not limited to loans similar in collateral, term and structure and loan purpose or type. We evaluate loan pools based on aggregated risk ratings, estimated specific loss potential in the different classes of credits, and historical loss experience by pool type. We adjust these quantitative factors for qualitative factors of present conditions. Qualitative factors include items such as economic and business conditions, changes in the portfolio, value of underlying collateral and concentrations. Residential mortgage loan pools exclude loans that have been restructured or impaired, as those loans are evaluated individually.

A rollforward of our valuation allowance and ending balances of the allowance and loan balance by basis of impairment method was as follows:

	<b>For the three months ended September 30, 2017</b>		
	<b>Commercial</b>	<b>Residential</b>	<b>Total</b>
		<i>(in millions)</i>	
Beginning balance	\$ 28.0	\$ 16.6	\$ 44.6
Provision	0.1	(1.2)	(1.1)
Charge-offs		(1.2)	(1.2)
Recoveries		1.4	1.4
Ending balance	\$ 28.1	\$ 15.6	\$ 43.7
	<b>For the nine months ended September 30, 2017</b>		
	<b>Commercial</b>	<b>Residential</b>	<b>Total</b>
		<i>(in millions)</i>	
Beginning balance	\$ 27.4	\$ 17.5	\$ 44.9
Provision	0.7	(1.2)	(0.5)
Charge-offs		(4.3)	(4.3)

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

Recoveries					
Ending balance	\$	28.1	\$	15.6	\$ 3.6
					43.7
Allowance ending balance by basis of impairment method:					
Individually evaluated for impairment	\$		\$	4.8	\$ 4.8
Collectively evaluated for impairment		28.1		10.8	38.9
Allowance ending balance	\$	28.1	\$	15.6	\$ 43.7
Loan balance by basis of impairment method:					
Individually evaluated for impairment	\$		\$	12.8	\$ 12.8
Collectively evaluated for impairment		12,773.5		1,277.8	14,051.3
Loan ending balance	\$	12,773.5	\$	1,290.6	\$ 14,064.1

28

---

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

	For the three months ended September 30, 2016		
	Commercial	Residential <i>(in millions)</i>	Total
Beginning balance	\$ 28.2	\$ 20.9	\$ 49.1
Provision	1.0	(2.3)	(1.3)
Charge-offs		(1.1)	(1.1)
Recoveries		1.2	1.2
Ending balance	\$ 29.2	\$ 18.7	\$ 47.9
	For the nine months ended September 30, 2016		
	Commercial	Residential <i>(in millions)</i>	Total
Beginning balance	\$ 27.5	\$ 24.1	\$ 51.6
Provision	1.7	(5.5)	(3.8)
Charge-offs		(2.7)	(2.7)
Recoveries		2.8	2.8
Ending balance	\$ 29.2	\$ 18.7	\$ 47.9
Allowance ending balance by basis of impairment method:			
Individually evaluated for impairment	\$ 2.9	\$ 6.3	\$ 9.2
Collectively evaluated for impairment	26.3	12.4	38.7
Allowance ending balance	\$ 29.2	\$ 18.7	\$ 47.9
Loan balance by basis of impairment method:			
Individually evaluated for impairment	\$ 9.5	\$ 19.8	\$ 29.3
Collectively evaluated for impairment	11,910.1	1,195.1	13,105.2
Loan ending balance	\$ 11,919.6	\$ 1,214.9	\$ 13,134.5

**Impaired Mortgage Loans**

Impaired mortgage loans are loans with a related specific valuation allowance, loans whose carrying amount has been reduced to the expected collectible amount because the impairment has been considered other than temporary or a loan modification has been classified as a troubled debt restructuring ( TDR ). Based on an assessment as to the collectability of the principal, a determination is made to apply any payments received either against the principal or according to the contractual terms of the loan. Our recorded investment in and unpaid principal balance of impaired loans along with the related loan specific allowance for losses, if any, and the average recorded investment and interest income recognized during the time the loans were impaired were as follows:

	September 30, 2017	
	Recorded investment	Unpaid principal balance <i>(in millions)</i>
		Related allowance

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

With no related allowance recorded:					
Residential-first liens	\$	0.6	\$	0.6	\$
With an allowance recorded:					
Residential-home equity		8.2		9.2	4.6
Residential-first liens		4.0		3.9	0.2
Total:					
Residential	\$	12.8	\$	13.7	\$ 4.8

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

	<b>Recorded investment</b>	<b>December 31, 2016 Unpaid principal balance</b>	<b>Related allowance</b>
		<i>(in millions)</i>	
With no related allowance recorded:			
Residential-first liens	\$ 1.5	\$ 1.5	\$
With an allowance recorded:			
Residential-home equity	13.0	14.1	5.5
Residential-first liens	4.7	4.6	0.4
Total:			
Residential	\$ 19.2	\$ 20.2	\$ 5.9

	<b>For the three months ended September 30, 2017</b>		<b>For the nine months ended September 30, 2017</b>	
	<b>Average recorded investment</b>	<b>Interest income recognized</b>	<b>Average recorded investment</b>	<b>Interest income recognized</b>
		<i>(in millions)</i>		
With no related allowance recorded:				
Residential-first liens	\$ 0.6	\$	\$ 1.1	\$
With an allowance recorded:				
Residential-home equity	8.4	0.1	10.6	0.2
Residential-first liens	4.1		4.4	0.1
Total:				
Residential	\$ 13.1	\$ 0.1	\$ 16.1	\$ 0.3

	<b>For the three months ended September 30, 2016</b>		<b>For the nine months ended September 30, 2016</b>	
	<b>Average recorded investment</b>	<b>Interest income recognized</b>	<b>Average recorded investment</b>	<b>Interest income recognized</b>
		<i>(in millions)</i>		
With no related allowance recorded:				
Residential-first liens	\$ 2.1	\$	\$ 2.8	\$
With an allowance recorded:				
Commercial-brick and mortar	4.8		4.8	
Residential-home equity	13.0	0.1	13.4	0.2
Residential-first liens	4.9		5.4	0.1
Total:				
Commercial	\$ 4.8	\$	\$ 4.8	\$
Residential	\$ 20.0	\$ 0.1	\$ 21.6	\$ 0.3

**Mortgage Loan Modifications**

Our commercial and residential mortgage loan portfolios can include loans that have been modified. We assess loan modifications on a case-by-case basis to evaluate whether a TDR has occurred. When we have commercial mortgage loan TDRs, they are modified to delay or reduce principal payments and to reduce or delay interest payments. The commercial mortgage loan modifications result in delayed cash receipts, a decrease in interest income and loan rates that are considered below market. When we have residential mortgage loan TDRs, they include modifications of interest-only payment periods, delays in principal balloon payments and interest rate reductions. Residential mortgage loan modifications result in delayed or decreased cash receipts and a decrease in interest income.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	<b>For the three months ended September 30, 2017</b>			
	<b>Number of contracts</b>	<b>TDRs</b>	<b>Recorded investment (in millions)</b>	<b>TDRs in payment default</b>
			<b>Number of contracts</b>	<b>Recorded investment (in millions)</b>
Residential-home equity	<b>3</b>	<b>\$</b>	<b>0.1</b>	<b>\$</b>
Residential-first liens	<b>1</b>		<b>0.1</b>	
Total	<b>4</b>	<b>\$</b>	<b>0.2</b>	<b>\$</b>
<b>For the three months ended September 30, 2016</b>				
	<b>Number of contracts</b>	<b>TDRs</b>	<b>Recorded investment (in millions)</b>	<b>TDRs in payment default</b>
			<b>Number of contracts</b>	<b>Recorded investment (in millions)</b>
Residential-home equity	<b>4</b>	<b>\$</b>	<b>0.2</b>	<b>\$</b>
Total	<b>4</b>	<b>\$</b>	<b>0.2</b>	<b>\$</b>
<b>For the nine months ended September 30, 2017</b>				
	<b>Number of contracts</b>	<b>TDRs</b>	<b>Recorded investment (in millions)</b>	<b>TDRs in payment default</b>
			<b>Number of contracts</b>	<b>Recorded investment (in millions)</b>
Residential-home equity	<b>10</b>	<b>\$</b>	<b>0.5</b>	<b>\$</b>
Residential-first liens	<b>1</b>		<b>0.1</b>	<b>1</b>
Total	<b>11</b>	<b>\$</b>	<b>0.6</b>	<b>1</b>
				<b>\$</b>
				<b>0.1</b>
				<b>0.1</b>
<b>For the nine months ended September 30, 2016</b>				
	<b>Number of contracts</b>	<b>TDRs</b>	<b>Recorded investment (in millions)</b>	<b>TDRs in payment default</b>
			<b>Number of contracts</b>	<b>Recorded investment (in millions)</b>
Residential-home equity	<b>7</b>	<b>\$</b>	<b>0.4</b>	<b>\$</b>
Residential-first liens	<b>1</b>		<b>0.1</b>	
Total	<b>8</b>	<b>\$</b>	<b>0.5</b>	<b>\$</b>

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



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

#### **Real Estate Transactions**

In September 2017, we entered an exchange agreement to exit certain real estate joint ventures. The transaction resulted in us transferring our interest in certain real estate properties in exchange for our joint venture partner's interest in certain other real estate properties. In a subsequent transaction we sold certain of these real estate properties to a third party. Both transactions closed in September 2017.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

We recognized a net pre-tax realized capital gain of \$690.9 million (net after-tax realized capital gain of \$410.8 million) for both the three and nine months ended September 30, 2017, as a result of these transactions. The following consolidated statement of financial position line items were most significantly impacted by the transactions, each having a net increase as of September 30, 2017, (in millions):

Real estate	\$	293.4
Other investments		222.4
Cash and cash equivalents		219.6
Long-term debt		49.4
Income taxes currently payable		179.1
Deferred income taxes		101.0

**Securities Posted as Collateral**

As of September 30, 2017 and December 31, 2016, we posted \$2,872.0 million and \$2,562.8 million, respectively, in commercial mortgage loans and home equity mortgages to satisfy collateral requirements associated with our obligation under funding agreements with Federal Home Loan Bank of Des Moines ( FHLB Des Moines ). In addition, as of September 30, 2017 and December 31, 2016, we posted \$2,384.7 million and \$2,233.2 million, respectively, in fixed maturities, available-for-sale securities to satisfy collateral requirements primarily associated with a reinsurance arrangement, our derivative credit support annex (collateral) agreements, Futures Commission Merchant ( FCM ) agreements, a lending arrangement and our obligation under funding agreements with FHLB Des Moines. Since we did not relinquish ownership rights on these instruments, they are reported as mortgage loans and fixed maturities, available-for-sale, respectively, on our consolidated statements of financial position. Of the securities posted as collateral, as of September 30, 2017 and December 31, 2016, \$150.1 million and \$272.8 million, respectively, could be sold or repledged by the secured party.

**Balance Sheet Offsetting**

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

Gross amount of recognized	Gross amounts not offset in the consolidated statements of financial position	
	Financial	Collateral

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

	assets (1)		instruments (2)		received		Net amount
				(in millions)			
<b>September 30, 2017</b>							
Derivative assets	\$	308.5	\$	(121.2)	\$	(179.1)	\$ 8.2
Reverse repurchase agreements		46.3				(46.3)	
Total	\$	354.8	\$	(121.2)	\$	(225.4)	\$ 8.2
<b>December 31, 2016</b>							
Derivative assets	\$	887.2	\$	(294.2)	\$	(582.0)	\$ 11.0
Reverse repurchase agreements		41.1				(41.1)	
Total	\$	928.3	\$	(294.2)	\$	(623.1)	\$ 11.0

(1) The gross amount of recognized derivative and reverse repurchase agreement assets are reported with other investments and cash and cash equivalents, respectively, on the consolidated statements of financial position. The above excludes \$12.7 million and \$6.4 million of derivative assets as of September 30, 2017 and December 31, 2016, respectively, that are not subject to master netting agreements or similar agreements. The gross amounts of derivative and reverse repurchase agreement assets are not netted against offsetting liabilities for presentation on the consolidated statements of financial position. See Note 1, Nature of Operations and Significant Accounting Policies, under the caption Over-The-Counter Derivatives Cleared on Chicago Mercantile Exchange for details of the CME variation margin rule change that impacted the amounts presented for 2017.

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

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	Gross amount of recognized liabilities (1)	Gross amounts not offset in the consolidated statements of financial position			Net amount
		Financial instruments (2)	Collateral pledged		
<i>(in millions)</i>					
<b>September 30, 2017</b>					
Derivative liabilities	\$ 260.1	\$ (121.2)	\$ (114.6)	\$	24.3
Repurchase agreements	15.1		(15.1)	\$	
Total	\$ 275.2	\$ (121.2)	\$ (129.7)	\$	24.3
<b>December 31, 2016</b>					
Derivative liabilities	\$ 567.5	\$ (294.2)	\$ (243.9)	\$	29.4
Repurchase agreements	9.7		(9.7)	\$	
Total	\$ 577.2	\$ (294.2)	\$ (253.6)	\$	29.4

(1) The gross amount of recognized derivative liabilities are reported with other liabilities on the consolidated statements of financial position. The above excludes \$385.0 million and \$394.3 million of derivative liabilities as of September 30, 2017 and December 31, 2016, respectively, which are primarily embedded derivatives that are not subject to master netting agreements or similar agreements. The gross amount of recognized repurchase agreement liabilities are reported with short-term debt on the consolidated statements of financial position. The gross amounts of derivative and repurchase agreement liabilities are not netted against offsetting assets for presentation on the consolidated statements of financial position. See Note 1, Nature of Operations and Significant Accounting Policies, under the caption Over-The-Counter Derivatives Cleared on Chicago Mercantile Exchange for details of the CME variation margin rule change that impacted the amounts presented for 2017.

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

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

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

#### **4. Derivative Financial Instruments**

Derivatives are generally used to hedge or reduce exposure to market risks associated with assets held or expected to be purchased or sold and liabilities incurred or expected to be incurred. Derivatives are used to change the characteristics of our asset/liability mix consistent with our risk management activities. Derivatives are also used in asset replication strategies.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**Types of Derivative Instruments**

*Interest Rate Contracts*

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

Interest rate swaps are contracts in which we agree with other parties to exchange, at specified intervals, the difference between fixed rate and floating rate interest amounts based upon designated market rates or rate indices and an agreed upon notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by any party. Cash is paid or received based on the terms of the swap. We use interest rate swaps primarily to more closely match the interest rate characteristics of assets and liabilities and to mitigate the risks arising from timing mismatches between assets and liabilities (including duration mismatches). We also use interest rate swaps to hedge against changes in the value of assets we anticipate acquiring and other anticipated transactions and commitments. Interest rate swaps are used to hedge against changes in the value of the guaranteed minimum withdrawal benefit ( GMWB ) liability. The GMWB rider on our variable annuity products provides for guaranteed minimum withdrawal benefits regardless of the actual performance of various equity and/or fixed income funds available with the product.

Interest rate options, including interest rate caps and interest rate floors, which can be combined to form interest rate collars, are contracts that entitle the purchaser to pay or receive the amounts, if any, by which a specified market rate exceeds a cap strike interest rate, or falls below a floor strike interest rate, respectively, at specified dates. We use interest rate collars to manage interest rate risk related to guaranteed minimum interest rate liabilities in our individual annuities contracts and lapse risk associated with higher interest rates.

A swaption is an option to enter into an interest rate swap at a future date. We purchase swaptions to offset or modify existing exposures. Swaptions provide us the benefit of the agreed-upon strike rate if the market rates for liabilities are higher, with the flexibility to enter into the current market rate swap if the market rates for liabilities are lower. Swaptions not only hedge against the downside risk, but also allow us to take advantage of any upside benefits.

In exchange-traded futures transactions, we agree to purchase or sell a specified number of contracts, the values of which are determined by the values of designated classes of securities, and to post variation margin on a daily basis in an amount equal to the difference in the daily market values of those contracts. We enter into exchange-traded futures with regulated futures commissions merchants who are members of a trading exchange. We have used exchange-traded futures to reduce market risks from changes in interest rates and to alter mismatches between the assets in a portfolio and the liabilities supported by those assets.

*Foreign Exchange Contracts*

Foreign currency risk is the risk we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from foreign currency-denominated funding agreements we issue, foreign currency-denominated fixed maturity and equity securities we invest in, capital transactions with our international operations and the financial results of our international operations. We use various derivatives to manage our exposure to fluctuations in foreign currency exchange rates.

Currency swaps are contracts in which we agree with other parties to exchange, at specified intervals, a series of principal and interest payments in one currency for that of another currency. Generally, the principal amount of each currency is exchanged at the beginning and termination of the currency swap by each party. The interest payments are primarily fixed-to-fixed rate; however, they may also be fixed-to-floating rate or floating-to-fixed rate. These transactions are entered into pursuant to master agreements that provide for a single net payment to be made by one counterparty for payments made in the same currency at each due date. We use currency swaps to reduce market risks from changes in currency exchange rates with respect to investments or liabilities denominated in foreign currencies that we either hold or intend to acquire or sell.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

Currency options are contracts that give the holder the right, but not the obligation to buy or sell a specified amount of the identified currency within a limited period of time at a contracted price. The contracts are net settled in cash, based on the differential in the current foreign exchange rate and the strike price. Purchased and sold options can be combined to form a foreign currency collar where we receive a payment if the foreign exchange rate is below the purchased option strike price and make a payment if the foreign exchange rate is above the sold option strike price. We use currency options to hedge expected cash flows from our foreign operations.

***Equity Contracts***

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

We purchase equity call spreads to hedge the equity participation rates promised to contractholders in conjunction with our fixed deferred annuity and universal life products that credit interest based on changes in an external equity index. We use exchange-traded futures and equity put options to hedge against changes in the value of the GMWB liability related to the GMWB rider on our variable annuity product, as previously explained. The premium associated with certain options is paid quarterly over the life of the option contract.

***Credit Contracts***

Credit risk relates to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest. We use credit default swaps to enhance the return on our investment portfolio by providing comparable exposure to fixed income securities that might not be available in the primary market. They are also used to hedge credit exposures in our investment portfolio. Credit derivatives are used to sell or buy credit protection on an identified name or names on an unfunded or synthetic basis in return for receiving or paying a quarterly premium. The premium generally corresponds to a referenced name's credit spread at the time the agreement is executed. In cases where we sell protection, we also buy a quality cash bond to match against the credit default swap, thereby entering into a synthetic transaction replicating a cash security. When selling protection, if there is an event of default by the referenced name, as defined by the agreement, we are obligated to pay the counterparty the referenced amount of the contract and receive in return the referenced security in a principal amount equal to the notional value of the credit default swap.



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

*Other Contracts*

*Embedded Derivatives.* We purchase or issue certain financial instruments or products that contain a derivative instrument that is embedded in the financial instrument or product. When it is determined that the embedded derivative possesses economic characteristics that are not clearly or closely related to the economic characteristics of the host contract and a separate instrument with the same terms would qualify as a derivative instrument, the embedded derivative is bifurcated from the host instrument for measurement purposes. The embedded derivative, which is reported with the host instrument in the consolidated statements of financial position, is carried at fair value.

We had investment contracts in which the return was tied to a leveraged inflation index. We economically hedged the risk associated with these investment contracts.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

We offer group annuity contracts that have guaranteed separate accounts as an investment option. We also offer funds with embedded fixed-rate guarantees as investment options in our defined contribution plans in Hong Kong.

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

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

**Exposure**

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

Derivatives may be exchange-traded or they may be privately negotiated contracts, which are usually referred to as OTC derivatives. Certain of our OTC derivatives are cleared and settled through central clearing counterparties ( OTC cleared ), while others are bilateral contracts between two counterparties ( bilateral OTC ). Our derivative transactions are generally documented under International Swaps and Derivatives Association, Inc. ( ISDA ) Master Agreements. Management believes that such agreements provide for legally enforceable set-off and close-out netting of exposures to specific counterparties. Under such agreements, in connection with an early termination of a transaction, we are permitted to set off our receivable from a counterparty against our payables to the same counterparty arising out of all included transactions. For reporting purposes, we do not offset fair value amounts of bilateral OTC derivatives for the right to reclaim cash collateral or the obligation to return cash collateral against fair value amounts recognized for derivative instruments executed with the same counterparties under master netting agreements. OTC cleared derivatives have variation margin that is legally characterized as settlement of the derivative exposure, which reduces their fair value in the consolidated statements of financial position.

We posted \$160.8 million and \$322.4 million in cash and securities under collateral arrangements as of September 30, 2017 and December 31, 2016, respectively, to satisfy collateral and initial margin requirements associated with our derivative credit support agreements and FCM agreements.

Certain of our derivative instruments contain provisions that require us to maintain an investment grade rating from each of the major credit rating agencies on our debt. If the ratings on our debt were to fall below investment grade, it would be in violation of these provisions and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value, inclusive of accrued interest, of all derivative instruments with credit-risk-related contingent features that were in a liability position without regard to netting under derivative credit support annex agreements as of September 30, 2017 and December 31, 2016, was \$258.4 million and \$454.7 million, respectively. Cleared derivatives have contingent features that require us to post excess margin as required by the FCM. The terms surrounding excess margin vary by FCM agreement. With respect to derivatives containing collateral triggers, we posted collateral and initial margin of \$160.8 million and \$322.4 million as of September 30, 2017 and December 31, 2016, respectively, in the normal course of business, which reflects netting under derivative agreements. If the credit-risk-related contingent features underlying these agreements were triggered on September 30, 2017, we would be required to post an additional \$40.8 million of collateral to our counterparties.

As of September 30, 2017 and December 31, 2016, we had received \$172.6 million and \$576.3 million, respectively, of cash collateral associated with our derivative credit support annex agreements and FCM agreements, for which we recorded a corresponding liability reflecting our obligation to return the collateral.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

Notional amounts are used to express the extent of our involvement in derivative transactions and represent a standard measurement of the volume of our derivative activity. Notional amounts represent those amounts used to calculate contractual flows to be exchanged and are not paid or received, except for contracts such as currency swaps. Credit exposure represents the gross amount owed to us under derivative contracts as of the valuation date. The notional amounts and credit exposure of our derivative financial instruments by type were as follows:

	September 30, 2017		December 31, 2016
	<i>(in millions)</i>		
<b>Notional amounts of derivative instruments</b>			
<b><i>Interest rate contracts:</i></b>			
Interest rate swaps	\$ 24,048.9	\$	23,520.4
Interest rate options	4,028.2		4,950.5
Interest rate futures	64.0		96.0
Swaptions	14.0		77.0
<b><i>Foreign exchange contracts:</i></b>			
Currency swaps	959.0		1,552.0
Currency forwards	819.9		851.3
Currency options	484.1		
<b><i>Equity contracts:</i></b>			
Equity options	3,456.3		3,505.8
Equity futures	325.4		545.1
<b><i>Credit contracts:</i></b>			
Credit default swaps	750.5		961.3
Total return swaps			90.0
Futures			11.9
<b><i>Other contracts:</i></b>			
Embedded derivatives	10,380.1		10,209.5
Total notional amounts at end of period	\$ 45,330.4	\$	46,370.8
<b>Credit exposure of derivative instruments</b>			
<b><i>Interest rate contracts:</i></b>			
Interest rate swaps	\$ 189.6	\$	733.1
Interest rate options	24.1		27.3
<b><i>Foreign exchange contracts:</i></b>			
Currency swaps	82.9		106.2
Currency forwards	17.0		6.4
Currency options	0.5		
<b><i>Equity contracts:</i></b>			
Equity options	15.4		28.2
<b><i>Credit contracts:</i></b>			
Credit default swaps	5.8		7.0
Total return swaps			0.7
Total gross credit exposure	335.3		908.9
Less: collateral received	200.2		586.8
Net credit exposure	\$ 135.1	\$	322.1



Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	Derivative assets (1)		Derivative liabilities (2)	
	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016
	<i>(in millions)</i>			
<b>Derivatives designated as hedging instruments</b>				
Interest rate contracts	\$ 0.9	\$ 4.4	\$ 27.4	\$ 71.3
Foreign exchange contracts	50.9	86.8	26.1	143.4
Total derivatives designated as hedging instruments	\$ 51.8	\$ 91.2	\$ 53.5	\$ 214.7
<b>Derivatives not designated as hedging instruments</b>				
Interest rate contracts	\$ 196.9	\$ 739.3	\$ 42.1	\$ 200.6
Foreign exchange contracts	51.5	27.2	32.3	56.2
Equity contracts	15.4	28.2	135.0	95.9
Credit contracts	5.6	7.7	1.5	5.7
Other contracts			380.7	388.7
Total derivatives not designated as hedging instruments	269.4	802.4	591.6	747.1
Total derivative instruments	\$ 321.2	\$ 893.6	\$ 645.1	\$ 961.8

(1) The fair value of derivative assets is reported with other investments on the consolidated statements of financial position.

(2) The fair value of derivative liabilities is reported with other liabilities on the consolidated statements of financial position, with the exception of certain embedded derivative liabilities. Embedded derivative liabilities with a fair value of \$138.2 million and \$176.5 million as of September 30, 2017 and December 31, 2016, respectively, are reported with contractholder funds on the consolidated statements of financial position.

**Credit Derivatives Sold**

When we sell credit protection, we are exposed to the underlying credit risk similar to purchasing a fixed maturity security instrument. The majority of our credit derivative contracts sold reference a single name or reference security (referred to as single name credit default swaps ). The remainder of our credit derivatives reference either a basket or index of securities. These instruments are either referenced in an OTC credit derivative transaction or embedded within an investment structure that has been fully consolidated into our financial statements.

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

These credit derivative transactions are subject to events of default defined within the terms of the contract, which normally consist of bankruptcy, failure to pay, or modified restructuring of the reference entity and/or issue. If a default event occurs for a reference name or security, we are obligated to pay the counterparty an amount equal to the notional amount of the credit derivative transaction. As a result, our maximum future payment is equal to the notional amount of the credit derivative. In certain cases, we also have purchased credit protection with identical underlyings to certain of our sold protection transactions. As of September 30, 2017 and December 31, 2016, we did not purchase credit protection relating to our sold protection transactions. In certain circumstances, our potential loss could also be reduced by any amount recovered in the default proceedings of the underlying credit name.

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

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

	September 30, 2017			Weighted average expected life (in years)
Notional amount	Fair value <i>(in millions)</i>	Maximum future payments		

	December 31, 2016			Weighted average expected life (in years)
Notional amount	Fair value <i>(in millions)</i>	Maximum future payments		
<b>Single name credit default swaps</b>				
Corporate debt				
AAA	\$ 30.0	\$ 0.6	\$ 30.0	2.2
AA	94.0	0.8	94.0	1.2
A	145.0	1.2	145.0	1.3
BBB	290.0	2.3	290.0	2.1
B	20.0	(1.8)	20.0	2.8
Near default	10.0	0.2	10.0	3.0
Government/municipalities				
AA	30.0	0.4	30.0	2.3
Sovereign				
AA	10.0	0.1	10.0	2.7



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

BBB	40.0	0.3	40.0	2.7
Total single name credit default swaps	669.0	4.1	669.0	1.9
<b>Basket and index credit default swaps</b>				
Corporate debt				
Near default (1)	82.3	(1.6)	82.3	0.2
Government/municipalities				
AA	30.0	(0.4)	30.0	0.7
Structured finance				
AA	3.5		3.5	0.8
Total basket and index credit default swaps	115.8	(2.0)	115.8	0.4
Total credit default swap protection sold	\$ 784.8	\$ 2.1	\$ 784.8	1.7

(1) Includes \$60.0 million as of December 31, 2016, notional of derivatives in consolidated collateralized private investment vehicle VIEs where the credit risk is borne by third party investors.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

We also have invested in fixed maturities classified as trading that contain credit default swaps. These securities are subject to the credit risk of the issuer, normally a special purpose vehicle, which consists of the underlying credit default swaps and high quality fixed maturities that serve as collateral. A default event occurs if the cumulative losses exceed a specified attachment point, which is typically not the first loss of the portfolio. If a default event occurs that exceeds the specified attachment point, our investment may not be fully returned. We would have no future potential payments under these investments. The following tables show, by the types of referenced/underlying asset class and external rating, our fixed maturities with embedded credit derivatives.

	September 30, 2017		Weighted average expected life (in years)
	Amortized cost	Carrying value	
	<i>(in millions)</i>		
<b>Structured finance</b>			
AA	\$ 1.8	\$ 1.8	0.1
Total structured finance	1.8	1.8	0.1
Total fixed maturities with credit derivatives	\$ 1.8	\$ 1.8	0.1

	December 31, 2016		Weighted average expected life (in years)
	Amortized cost	Carrying value	
	<i>(in millions)</i>		
[REDACTED]			

**Fair Value Hedges**

We use fixed-to-floating rate interest rate swaps to more closely align the interest rate characteristics of certain assets and liabilities. In general, these swaps are used in asset and liability management to modify duration, which is a measure of sensitivity to interest rate changes.

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

We enter into currency exchange swap agreements to convert certain foreign denominated assets and liabilities into U.S. dollar floating-rate denominated instruments to eliminate the exposure to future currency volatility on those items.

The net interest effect of interest rate swap and currency swap transactions for derivatives in fair value hedges is recorded as an adjustment to income or expense of the underlying hedged item in our consolidated statements of operations.

Hedge effectiveness testing for fair value relationships is performed utilizing a regression analysis approach for both prospective and retrospective evaluations. This regression analysis will consider multiple data points for the assessment that the hedge continues to be highly effective in achieving offsetting changes in fair value. In certain periods, the comparison of the change in value of the derivative and the change in the value of the hedged item may not be offsetting at a specific period in time due to small movements in value. However, any amounts recorded as fair value hedges have shown to be highly effective in achieving offsetting changes in fair value both for present and future periods.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

The following table shows the effect of derivatives in fair value hedging relationships and the related hedged items on the consolidated statements of operations. All gains or losses on derivatives were included in the assessment of hedge effectiveness.

Derivatives in fair value hedging relationships	Amount of gain (loss) recognized in net income on derivatives for the three months ended September 30, (1)		Hedged items in fair value hedging relationships	Amount of gain (loss) recognized in net income on related hedged item for the three months ended September 30, (1)	
	2017	2016		2017	2016
	<i>(in millions)</i>			<i>(in millions)</i>	
Interest rate contracts	\$ 1.1	\$ 8.9	Fixed maturities, available-for-sale	\$ (1.1)	\$ (8.5)
Interest rate contracts	0.1	(1.9)	Investment contracts	(0.1)	2.0
Total	\$ 1.2	\$ 7.0	Total	\$ (1.2)	\$ (6.5)

Derivatives in fair value hedging relationships	Amount of gain (loss) recognized in net income on derivatives for the nine months ended September 30, (1)		Hedged items in fair value hedging relationships	Amount of gain (loss) recognized in net income on related hedged item for the nine months ended September 30, (1)	
	2017	2016		2017	2016
	<i>(in millions)</i>			<i>(in millions)</i>	
Interest rate contracts	\$ 2.1	\$ 1.3	Fixed maturities, available-for-sale	\$ (2.4)	\$ (0.9)
Interest rate contracts	(0.6)	1.4	Investment contracts	0.6	(1.3)
Total	\$ 1.5	\$ 2.7	Total	\$ (1.8)	\$ (2.2)

(1) The gain (loss) on both derivatives and hedged items in fair value relationships is reported in net realized capital gains (losses) on the consolidated statements of operations. The net amount represents the ineffective portion of our fair value hedges.

The following table shows the periodic settlements on interest rate contracts and foreign exchange contracts in fair value hedging relationships.

Hedged item	Amount of gain (loss) for the three months ended September 30,		Amount of gain (loss) for the nine months ended September 30,	
	2017	2016	2017	2016
	<i>(in millions)</i>			

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

Fixed maturities, available-for-sale (1)	\$	(2.4)	\$	(9.6)	\$	(8.1)	\$	(34.6)
Investment contracts (2)		0.1		0.6		0.9		2.0

- (1) Reported in net investment income on the consolidated statements of operations.
- (2) Reported in benefits, claims and settlement expenses on the consolidated statements of operations.

### Cash Flow Hedges

We utilize floating-to-fixed rate interest rate swaps to eliminate the variability in cash flows of recognized financial assets and liabilities and forecasted transactions.

We enter into currency exchange swap agreements to convert both principal and interest payments of certain foreign denominated assets and liabilities into U.S. dollar denominated fixed-rate instruments to eliminate the exposure to future currency volatility on those items.

The net interest effect of interest rate swap and currency swap transactions for derivatives in cash flow hedges is recorded as an adjustment to income or expense of the underlying hedged item in our consolidated statements of operations.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

The maximum length of time we are hedging our exposure to the variability in future cash flows for forecasted transactions, excluding those related to the payments of variable interest on existing financial assets and liabilities, is 2.8 years. As of September 30, 2017, we had \$3.5 million of net gains reported in AOCI on the consolidated statements of financial position related to active hedges of forecasted transactions. If a hedged forecasted transaction is no longer probable of occurring, cash flow hedge accounting is discontinued. If it is probable that the hedged forecasted transaction will not occur, the deferred gain or loss is immediately reclassified from AOCI into net income. During the nine months ended September 30, 2017 and 2016, we did not have any reclassifications from AOCI into net realized capital gains (losses) as a result of the determination that hedged cash flows were probable of not occurring.

The following table shows the effect of derivatives in cash flow hedging relationships on the consolidated statements of operations and consolidated statements of financial position. All gains or losses on derivatives were included in the assessment of hedge effectiveness.

Derivatives in cash flow hedging relationships	Related hedged item	Amount of gain (loss) recognized in AOCI on derivatives (effective portion) for the three months ended September 30,		Location of gain (loss) reclassified from AOCI into net income (effective portion)	Amount of gain (loss) reclassified from AOCI on derivatives (effective portion) for the three months ended September 30,	
		2017	2016		2017	2016
		<i>(in millions)</i>			<i>(in millions)</i>	
Interest rate contracts	Fixed maturities, available-for-sale	\$ (5.1)	\$ (35.3)	Net investment income	\$ 5.4	\$ 4.9
Interest rate contracts	Debt			Operating expense	(2.8)	(2.3)
Foreign exchange contracts	Fixed maturities, available-for-sale	(17.1)	(2.0)	Net realized capital losses	(0.1)	
Foreign exchange contracts	Investment contracts		1.3	Benefits, claims and settlement expenses		
Total		\$ (22.2)	\$ (36.0)	Total	\$ 2.5	\$ 2.6

Derivatives in cash flow hedging relationships	Related hedged item	Amount of gain (loss) recognized in AOCI on derivatives (effective portion) for the nine months ended September 30,		Location of gain (loss) reclassified from AOCI into net income (effective portion)	Amount of gain (loss) reclassified from AOCI on derivatives (effective portion) for the nine months ended September 30,	
		2017	2016		2017	2016
		<i>(in millions)</i>			<i>(in millions)</i>	
Interest rate contracts	Fixed maturities, available-for-sale	\$ (44.2)	\$ (13.6)	Net investment income	\$ 15.7	\$ 14.3
Interest rate contracts				Net realized capital losses	(0.7)	
Interest rate contracts	Investment contracts		1.6	Benefits, claims and settlement expenses		
Interest rate contracts	Debt			Operating expense	(8.0)	(6.8)

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

Foreign exchange contracts	Fixed maturities, available-for-sale	(46.7)		3.5	Net realized capital gains	14.0		1.2
Foreign exchange contracts	Investment contracts	0.1		5.2	Benefits, claims and settlement expenses			
Total		\$ (90.8)	\$	(3.3)	Total	\$ 21.0	\$	8.7

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

The following table shows the periodic settlements on interest rate contracts and foreign exchange contracts in cash flow hedging relationships.

Hedged item	Amount of gain (loss) for the three months ended September 30,		Amount of gain (loss) for the nine months ended September 30,	
	2017	2016	2017	2016
			<i>(in millions)</i>	
Fixed maturities, available-for-sale (1)	\$ 1.9	\$ 1.4	\$ 5.3	\$ 4.3
Investment contracts (2)	(0.1)	(3.5)	(1.0)	(12.8)

(1) Reported in net investment income on the consolidated statements of operations.

(2) Reported in benefits, claims and settlement expenses on the consolidated statements of operations.

The ineffective portion of our cash flow hedges is reported in net realized capital gains (losses) on the consolidated statements of operations. The net gain (loss) resulting from the ineffective portion of derivatives in cash flow hedging relationships was \$0.0 million and \$0.1 million for the three months ended September 30, 2017 and 2016, respectively. The net gain (loss) resulting from the ineffective portion of derivatives in cash flow hedging relationships was \$0.0 million and \$0.0 million for the nine months ended September 30, 2017 and 2016, respectively.

We expect to reclassify net gains of \$16.9 million from AOCI into net income in the next 12 months, which includes net deferred gains on discontinued hedges and net losses on periodic settlements of active hedges. Actual amounts may vary from this amount as a result of market conditions.

#### **Derivatives Not Designated as Hedging Instruments**

Our use of futures, certain swaptions and swaps, collars, options and forwards are effective from an economic standpoint, but they have not been designated as hedges for financial reporting purposes. As such, periodic changes in the market value of these instruments, which includes mark-to-market gains and losses as well as periodic and final settlements, primarily flow directly into net realized capital gains (losses) on the consolidated statements of operations.

The following table shows the effect of derivatives not designated as hedging instruments, including fair value changes of embedded derivatives that have been bifurcated from the host contract, on the consolidated statements of operations.



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

Derivatives not designated as hedging instruments	Amount of gain (loss) recognized in net income on derivatives for the three months ended September 30,		Amount of gain (loss) recognized in net income on derivatives for the nine months ended September 30,	
	2017	2016	2017	2016
	<i>(in millions)</i>			
Interest rate contracts	\$ (2.0)	\$ 29.0	\$ (46.2)	\$ 289.7
Foreign exchange contracts	28.7	9.1	47.0	32.2
Equity contracts	(63.8)	(61.6)	(162.5)	(46.6)
Credit contracts	(3.7)	14.6	(16.1)	39.1
Other contracts	8.1	(2.3)	33.9	(152.6)
Total	\$ (32.7)	\$ (11.2)	\$ (143.9)	\$ 161.8

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**5. Insurance Liabilities****Liability for Unpaid Claims**

The liability for unpaid claims is reported in future policy benefits and claims within our consolidated statements of financial position. Activity associated with unpaid claims was as follows:

	For the nine months ended September 30,	
	2017	2016
	<i>(in millions)</i>	
Balance at beginning of period	\$ 2,001.3	\$ 1,872.2
Less reinsurance recoverable	340.3	314.1
Net balance at beginning of period	1,661.0	1,558.1
Incurred:		
Current year	867.2	816.4
Prior years	42.2	30.7
Total incurred	909.4	847.1
Payments:		
Current year	527.8	500.5
Prior years	318.3	266.5
Total payments	846.1	767.0
Net balance at end of period	1,724.3	1,638.2
Plus reinsurance recoverable	369.9	334.8
Balance at end of period	\$ 2,094.2	\$ 1,973.0
Amounts not included in the rollforward above:		
Claim adjustment expense liabilities	\$ 50.5	\$ 49.2

Incurred liability adjustments relating to prior years, which affected current operations during 2017 and 2016, resulted in part from developed claims for prior years being different than were anticipated when the liabilities for unpaid claims were originally estimated. These trends have been considered in establishing the current year liability for unpaid claims.

**6. Income Taxes****Effective Income Tax Rate**

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

Our provision for income taxes may not have the customary relationship of taxes to income. A reconciliation between the U.S. corporate income tax rate and the effective income tax rate was as follows:

	For the three months ended		For the nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
U.S. corporate income tax rate	35 %	35 %	35 %	35 %
Dividends received deduction	(4)	(11)	(7)	(10)
Tax credits	(2)	(4)	(2)	(2)
Impact of equity method presentation	(1)	(3)	(2)	(3)
Local country permanent tax adjustments	(1)	(2)	(1)	(1)
Interest exclusion from taxable income	(1)	(2)	(1)	(1)
Impact of noncontrolling interest presentation		(2)		(1)
State income taxes	4		2	
Other		1		(2)
Effective income tax rate	30 %	12 %	24 %	15 %

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**Unrecognized Tax Benefits**

A summary of the changes in unrecognized tax benefits follows:

	For the nine months ended September 30, 2017		For the year ended December 31, 2016	
	<i>(in millions)</i>			
Balance at beginning of period	\$	207.8	\$	219.0
Additions based on tax positions related to the current year		7.0		0.8
Additions for tax positions of prior years		19.3		0.8
Reductions for tax positions related to the current year		(0.3)		(12.6)
Reductions for tax positions of prior years		(0.5)		(0.2)
Settlements		(36.7)		
Balance at end of period (1)	\$	196.6	\$	207.8

(1) Of this amount, \$44.4 million, if recognized, would reduce the 2017 effective income tax rate. We recognize interest and penalties related to uncertain tax positions in operating expenses.

As of September 30, 2017 and December 31, 2016, we had recognized \$124.3 million and \$142.4 million of accumulated pre-tax interest and penalties related to unrecognized tax benefits, respectively.

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

	Pension benefits				Other postretirement benefits			
	For the three months ended September 30,		For the three months ended September 30,		For the three months ended September 30,		For the three months ended September 30,	
	2017	2016	2017	2016	2017	2016	2017	2016
	<i>(in millions)</i>							
Service cost	\$	16.7	\$	16.2	\$	1.0	\$	0.6
Interest cost		31.1		33.7		1.0		1.7

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

Expected return on plan assets		<b>(36.0)</b>		(38.7)		<b>(7.0)</b>		(8.1)
Amortization of prior service benefit		<b>(0.6)</b>		(0.6)		<b>(8.6)</b>		(5.1)
Recognized net actuarial (gain) loss		<b>17.0</b>		19.3		<b>(0.1)</b>		
Net periodic benefit cost (income)	\$	<b>28.2</b>	\$	29.9	\$	<b>(14.7)</b>	\$	(10.9)

	Pension benefits				Other postretirement benefits			
	For the nine months ended		For the nine months ended		For the nine months ended		For the nine months ended	
	2017	2016	2017	2016	2017	2016	2017	2016
	<i>(in millions)</i>							
Service cost	\$	<b>50.3</b>	\$	48.7	\$	<b>0.1</b>	\$	1.8
Interest cost		<b>93.3</b>		101.1		<b>3.0</b>		5.0
Expected return on plan assets		<b>(108.1)</b>		(116.2)		<b>(20.7)</b>		(24.4)
Amortization of prior service benefit		<b>(1.7)</b>		(1.7)		<b>(25.9)</b>		(15.2)
Recognized net actuarial (gain) loss		<b>51.0</b>		57.8		<b>(0.1)</b>		0.1
Net periodic benefit cost (income)	\$	<b>84.8</b>	\$	89.7	\$	<b>(43.6)</b>	\$	(32.7)

**Contributions**

Our funding policy for our qualified pension plan is to fund the plan annually in an amount at least equal to the minimum annual contribution required under the Employee Retirement Income Security Act ( ERISA ) and, generally, not greater than the maximum amount that can be deducted for federal income tax purposes. The minimum annual contribution for 2017 will be zero so we will not be required to fund our qualified pension plan during 2017. However, it is possible that we may fund the qualified and nonqualified pension plans in 2017 for a combined total of up to \$125.0 million. During the three and nine months ended September 30, 2017, we contributed \$13.2 million and \$83.5 million to these plans, respectively.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

**8. Contingencies, Guarantees and Indemnifications**

**Litigation and Regulatory Contingencies**

We are regularly involved in litigation, both as a defendant and as a plaintiff, but primarily as a defendant. Litigation naming us as a defendant ordinarily arises out of our business operations as a provider of asset management and accumulation products and services; individual life insurance, specialty benefits insurance and our investment activities. Some of the lawsuits may be class actions, or purport to be, and some may include claims for unspecified or substantial punitive and treble damages.

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

In addition, regulatory bodies such as state insurance departments, the SEC, the Financial Industry Regulatory Authority, the Department of Labor ( DOL ) and other regulatory agencies regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, ERISA and laws governing the activities of broker-dealers. We receive requests from regulators and other governmental authorities relating to industry issues and may receive additional requests, including subpoenas and interrogatories, in the future.

On December 30, 2015, Mary Ventura, William Littlejohn and Ryan Kadota filed a lawsuit in the United States District Court for the Southern District of Iowa against Principal Management Corporation ( PMC ). The lawsuit alleges PMC breached its fiduciary duty under Section 36(b) of the Investment Company Act by charging excessive fees on the LargeCap Growth I Fund, SmallCap Growth I Fund, SmallCap Fund, High Yield Fund, MidCap Fund and the MidCap Value III Fund. Plaintiffs' counsel dismissed this case with prejudice. The stipulation of dismissal was filed on October 16, 2017.

On August 29, 2013, American Chemicals & Equipment, Inc. 401(k) Retirement Plan ( ACE ) filed a lawsuit in the United States District Court for the Northern District of Alabama against PMC and Principal Global Investors, LLC (the ACE Defendants ). The lawsuit alleged the ACE Defendants breached their fiduciary duty under Section 36(b) of the Investment Company Act by charging excessive fees on certain of the LifeTime series target date funds. Principal Global Investors, LLC was dismissed from the case on December 29, 2015. PMC was granted summary judgment on February 8, 2016, and the case was dismissed. ACE appealed the grant of summary judgment and subsequent dismissal to the Eighth Circuit Court of Appeals. On July 24, 2017, the Eighth Circuit issued a decision affirming the grant of summary judgment in favor of

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

PMC and dismissing the case. Plaintiff elected not to file a petition for writ of certiorari to the U.S. Supreme Court; as such, the dismissal stands as affirmed and the case is concluded.

In 2008, Principal Life received approximately \$440.0 million in connection with the termination of certain structured transactions and the resulting prepayment of Principal Life's investment in those transactions. The transactions involved Lehman Brothers Special Financing Inc. and Lehman Brothers Holdings Inc. (collectively, Lehman) in various capacities. Subsequent to Lehman's 2008 bankruptcy filing, its bankruptcy estate initiated several lawsuits seeking to recover from numerous sources significant amounts to which it claims entitlement under various theories. We are one of a large group of defendants to this action. The estate's claim against Principal Life, including interest, was approximately \$600.0 million. On June 28, 2016, the bankruptcy court granted the Defendants' motion to dismiss directed at common issues and dismissed with prejudice all claims against Principal Life. Lehman has appealed the bankruptcy court's decision to the U.S. District Court for the Southern District of New York.

While the outcome of any pending or future litigation or regulatory matter cannot be predicted, management does not believe any such matter will have a material adverse effect on our business or financial position. As of September 30, 2017, we had no estimated losses accrued related to the legal matters discussed above because we believe the chance of loss from these matters is not probable and the amount of loss cannot be reasonably estimated.

Table of Contents

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2017**  
**(Unaudited)**

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

The outcome of such matters is always uncertain, and unforeseen results can occur. It is possible such outcomes could require us to pay damages or make other expenditures or establish accruals in amounts we could not estimate as of September 30, 2017.

**Guarantees and Indemnifications**

In the normal course of business, we have provided guarantees to third parties primarily related to former subsidiaries and joint ventures. The terms of these agreements range in duration and often are not explicitly defined. The maximum exposure under these agreements as of September 30, 2017, was approximately \$149.0 million. At inception, the fair value of such guarantees was insignificant. In addition, we believe the likelihood is remote that material payments will be required. Therefore, any liability accrued within our consolidated statements of financial position is insignificant. Should we be required to perform under these guarantees, we generally could recover a portion of the loss from third parties through recourse provisions included in agreements with such parties, the sale of assets held as collateral that can be liquidated in the event performance is required under the guarantees or other recourse generally available to us; therefore, such guarantees would not result in a material adverse effect on our business or financial position. While the likelihood is remote, such outcomes could materially affect net income in a particular quarter or annual period.

We manage mandatory privatized social security funds in Chile. By regulation, we have a required minimum guarantee on the funds' relative return. Because the guarantee has no limitation with respect to duration or amount, the maximum exposure of the guarantee in the future is indeterminable.

We are also subject to various other indemnification obligations issued in conjunction with divestitures, acquisitions and financing transactions whose terms range in duration and often are not explicitly defined. Certain portions of these indemnifications may be capped, while other portions are not subject to such limitations; therefore, the overall maximum amount of the obligation under the indemnifications cannot be reasonably estimated. At inception, the fair value of such indemnifications was insignificant. In addition, we believe the likelihood is remote that material payments will be required. Therefore, any liability accrued within our consolidated statements of financial position is insignificant. While we are unable to estimate with certainty the ultimate legal and financial liability with respect to these indemnifications, we believe that performance under these indemnifications would not result in a material adverse effect on our business or financial position. While the likelihood is remote, performance under these indemnifications could materially affect net income in a particular quarter or annual period.

**9. Stockholders' Equity**



**Reconciliation of Outstanding Common Shares**

	<b>For the nine months ended September 30,</b>	
	<b>2017</b>	<b>2016</b>
	<i>(in millions)</i>	
Beginning balance	<b>287.7</b>	291.4
Shares issued	<b>4.3</b>	2.5
Treasury stock acquired	<b>(3.5)</b>	(6.2)
Ending balance	<b>288.5</b>	287.7

In October 2015, our Board of Directors authorized a share repurchase program of up to \$150.0 million of our outstanding common stock, which was completed in March 2016. In February 2016, our Board of Directors authorized a share repurchase program of up to \$400.0 million of our outstanding common stock. In May 2017, our Board of Directors authorized a share repurchase program of up to \$250.0 million of our outstanding common stock. Shares repurchased under these programs are accounted for as treasury stock, carried at cost and reflected as a reduction to stockholders' equity.

Table of Contents

**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**September 30, 2017**

**(Unaudited)**

**Other Comprehensive Income**

<b>For the three months ended</b>			<b>For the nine months ended</b>		
<b>September 30, 2017</b>			<b>September 30, 2017</b>		
<b>Pre-Tax</b>	<b>Tax</b>	<b>After-Tax</b>	<b>Pre-Tax</b>	<b>Tax</b>	<b>After-Tax</b>

*(in millions)*

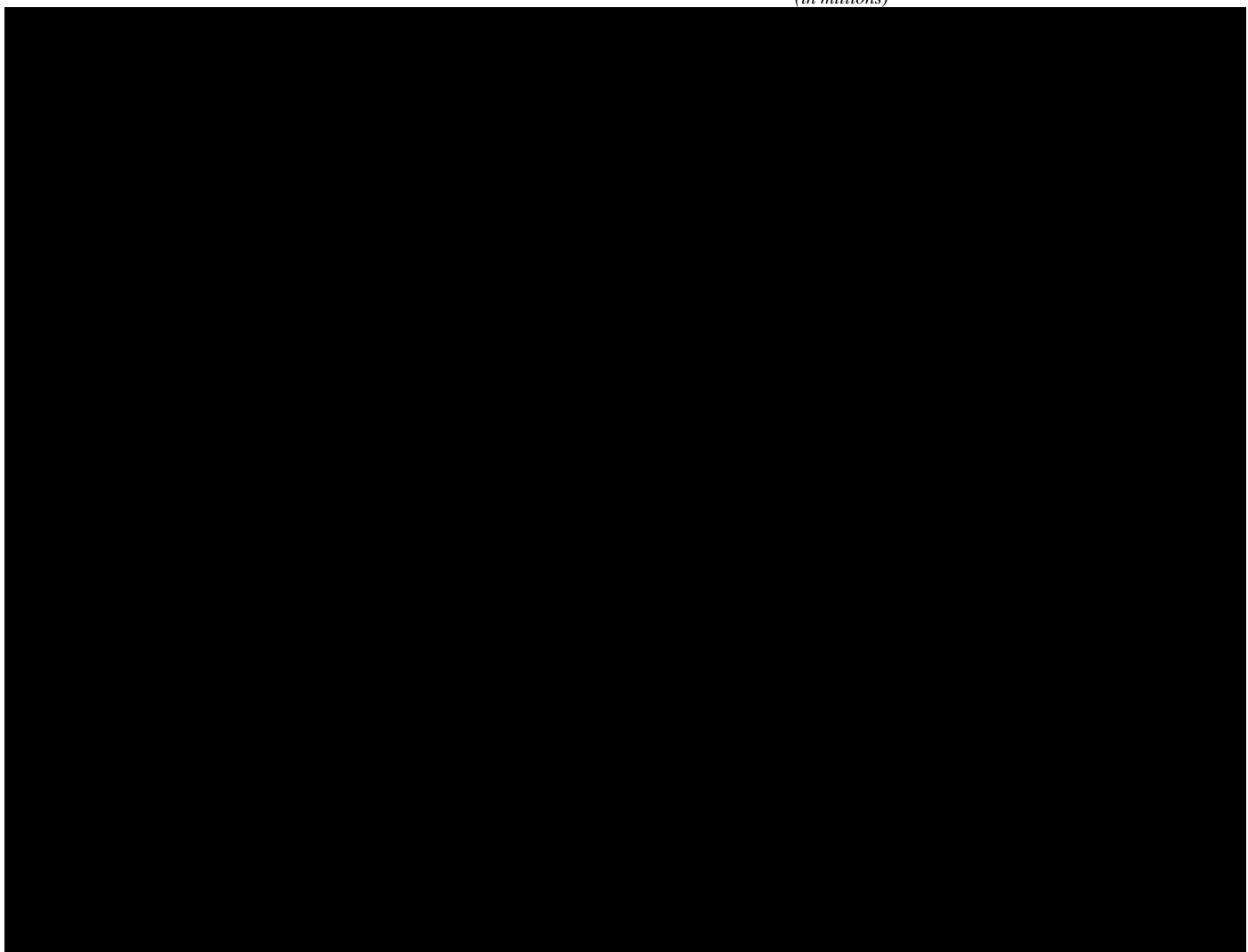




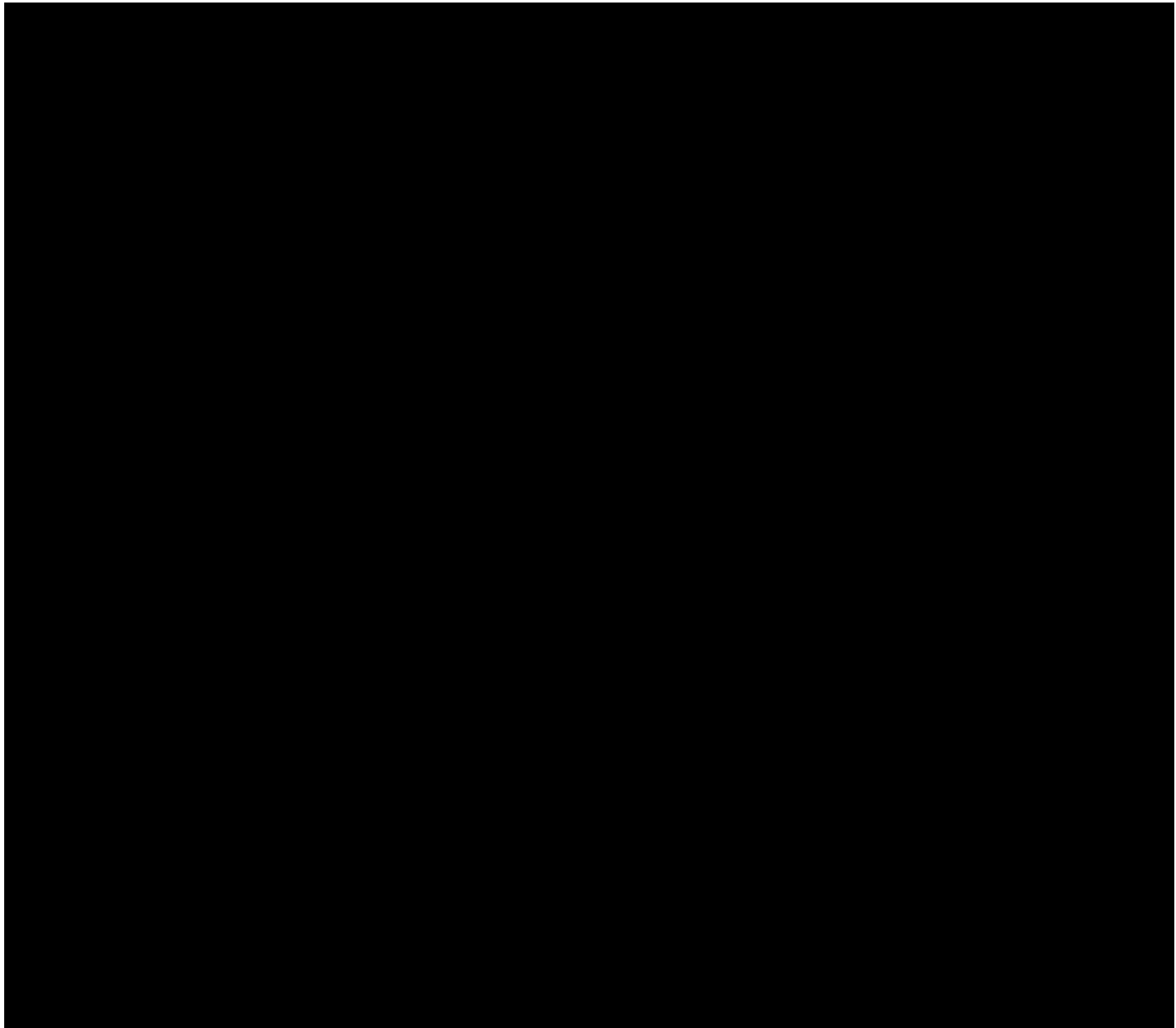
Table of Contents

**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**September 30, 2017**

**(Unaudited)**



- (1) Pre-tax reclassification adjustments relating to available-for-sale securities are reported in net realized capital gains (losses) on the consolidated statements of operations.
- (2) Represents the net impact of (1) unrealized gains resulting from reclassification of previously recognized noncredit impairment losses from OCI to net realized capital gains (losses) for fixed maturities with bifurcated OTTI that had additional credit losses or fixed maturities that previously had bifurcated OTTI that have now been sold or are intended to be sold and (2) unrealized losses resulting from reclassification of noncredit impairment losses for fixed maturities with bifurcated OTTI from net realized capital gains (losses) to OCI.
- (3) See Note 4, Derivative Financial Instruments – Cash Flow Hedges, for further details.
- (4) Amount is comprised of amortization of prior service cost (benefit) and recognized net actuarial (gain) loss, which is reported in operating expenses on the consolidated statements of operations. See Note 7, Employee and Agent Benefits – Components of Net Periodic Benefit Cost, for further details.

Table of Contents**Principal Financial Group, Inc.****Notes to Consolidated Financial Statements (continued)****September 30, 2017****(Unaudited)****Accumulated Other Comprehensive Income (Loss)**

	Net unrealized gains on available-for-sale securities	Noncredit component of impairment losses on fixed maturities available-for-sale	Net unrealized gains on derivative instruments	Foreign currency translation adjustment	Unrecognized postretirement benefit obligation	Accumulated other comprehensive income (loss)
	<i>(in millions)</i>					
<b>Balances as of January 1, 2016</b>	\$ 732.1	\$ (86.0)	\$ 69.8	\$ (1,148.2)	\$ (450.2)	\$ (882.5)
Other comprehensive income during the period, net of adjustments	816.5	(6.9)	22.2	122.4		954.2
Amounts reclassified from AOCI	11.4		(6.0)		24.0	29.4
Other comprehensive income	827.9	(6.9)	16.2	122.4	24.0	983.6
Purchase of subsidiary shares from noncontrolling interest				(9.3)		(9.3)
<b>Balances as of September 30, 2016</b>	\$ 1,560.0	\$ (92.9)	\$ 86.0	\$ (1,035.1)	\$ (426.2)	\$ 91.8
<b>Balances as of January 1, 2017</b>	\$ 831.2	\$ (89.5)	\$ 85.3	\$ (1,093.8)	\$ (408.4)	\$ (675.2)
Other comprehensive income during the period, net of adjustments	536.2		(15.5)	148.6		669.3
Amounts reclassified from AOCI	32.9	21.0	(13.8)		12.8	52.9
Other comprehensive income	569.1	21.0	(29.3)	148.6	12.8	722.2
<b>Balances as of September 30, 2017</b>	\$ 1,400.3	\$ (68.5)	\$ 56.0	\$ (945.2)	\$ (395.6)	\$ 47.0

**Noncontrolling Interest**

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

The noncontrolling interest holders in certain of our consolidated entities maintain an equity interest that is redeemable at the option of the holder, which may be exercised on varying dates. Since redemption of the noncontrolling interest is outside of our control, this interest is presented on the consolidated statements of financial position line item titled Redeemable noncontrolling interest. Our redeemable

noncontrolling interest primarily relates to consolidated sponsored investment funds for which interests are redeemed at fair value from the net assets of the funds.

For our redeemable noncontrolling interest related to other consolidated subsidiaries, redemptions are required to be purchased at fair value or a value based on a formula that management intended to reasonably approximate fair value based on a fixed multiple of earnings over a measurement period. The carrying value of the redeemable noncontrolling interest is compared to the redemption value at each reporting period. Any adjustments to the carrying amount of the redeemable noncontrolling interest for changes in redemption value prior to exercise of the redemption option are determined after the attribution of net income or loss of the subsidiary and are recognized in the redemption value as they occur. Adjustments to the carrying value of redeemable noncontrolling interest result in adjustments to additional paid-in capital and/or retained earnings. Adjustments are recorded in retained earnings to the extent the redemption value of the redeemable noncontrolling interest exceeds its fair value and will impact the numerator in our earnings per share calculations. All other adjustments to the redeemable noncontrolling interest are recorded in additional paid-in capital.

Table of Contents**Principal Financial Group, Inc.****Notes to Consolidated Financial Statements (continued)****September 30, 2017****(Unaudited)**

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

<b>Balance as of January 1, 2016</b>	\$	85.7
Net income attributable to redeemable noncontrolling interest		20.8
Redeemable noncontrolling interest of newly consolidated entities (1)		179.5
Redeemable noncontrolling interest of deconsolidated entities (2)		(181.2)
Contributions from redeemable noncontrolling interest		132.5
Distributions to redeemable noncontrolling interest		(46.9)
Purchase of subsidiary shares from redeemable noncontrolling interest		(8.2)
Change in redemption value of redeemable noncontrolling interest		4.1
Other comprehensive income attributable to redeemable noncontrolling interest		3.6
<b>Balance as of September 30, 2016</b>	\$	189.9
<b>Balance as of January 1, 2017</b>	\$	97.5
Net income attributable to redeemable noncontrolling interest		6.9
Redeemable noncontrolling interest of deconsolidated entities (2)		(1.4)
Contributions from redeemable noncontrolling interest		54.5
Distributions to redeemable noncontrolling interest		(28.2)
Purchase of subsidiary shares from redeemable noncontrolling interest		(4.4)
Change in redemption value of redeemable noncontrolling interest		2.8
Other comprehensive income attributable to redeemable noncontrolling interest		1.4
<b>Balance as of September 30, 2017</b>	\$	129.1

(1) Effective January 1, 2016, certain sponsored investment funds were consolidated as a result of the implementation of new accounting guidance.

(2) We deconsolidated certain sponsored investment funds as they no longer met the requirements for consolidation.

**Dividend Limitations**

Under Iowa law, Principal Life may pay dividends only from the earned surplus arising from its business and must receive the prior approval of the Commissioner of Insurance of the State of Iowa (the Commissioner) to pay stockholder dividends or make any other distribution if such dividends or distributions would exceed certain statutory limitations. Iowa law gives the Commissioner discretion to disapprove requests for distributions in excess of these limitations. Extraordinary dividends include those made, together with dividends and other distributions, within the preceding twelve months that exceed 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, not to exceed earned surplus. Based on December 31, 2016, statutory results, the dividend limitation for Principal Life is approximately \$1,143.3 million in ordinary dividends in 2017 without prior regulatory approval. However, because the dividend test is based on dividends previously paid over rolling 12-month periods, if paid before a specified date during 2017, some or all of such dividends may be extraordinary and require regulatory approval.



On May 1, 2017, Principal Life sold its ownership interest in Principal Global Investors, LLC to Principal Life's direct parent, Principal Financial Services, Inc. in connection with a corporate reorganization designed to better utilize and allocate capital internally. Subsequent to the sale, Principal Life paid an extraordinary dividend of \$1,068.4 million to its parent, which was approved by the Commissioner, primarily from proceeds received from the sale.

#### **10. Fair Value Measurements**

We use fair value measurements to record fair value of certain assets and liabilities and to estimate fair value of financial instruments not recorded at fair value but required to be disclosed at fair value. Certain financial instruments, particularly policyholder liabilities other than investment contracts, are excluded from these fair value disclosure requirements.

Table of Contents

**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**September 30, 2017**

**(Unaudited)**

**Valuation Hierarchy**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three levels. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety considering factors specific to the asset or liability.

- **Level 1** Fair values are based on unadjusted quoted prices in active markets for identical assets or liabilities. Our Level 1 assets and liabilities primarily include exchange traded equity securities, mutual funds and U.S. Treasury bonds.
- **Level 2** Fair values are based on inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. Our Level 2 assets and liabilities primarily include fixed maturities (including public and private bonds), equity securities, cash equivalents, derivatives and other investments.
- **Level 3** Fair values are based on at least one significant unobservable input for the asset or liability. Our Level 3 assets and liabilities primarily include fixed maturities, real estate and commercial mortgage loan investments of our separate accounts, complex derivatives and embedded derivatives.

**Determination of Fair Value**

The following discussion describes the valuation methodologies and inputs used for assets and liabilities measured at fair value on a recurring basis or disclosed at fair value. The techniques utilized in estimating the fair value of financial instruments are reliant on the assumptions used. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

Fair value estimates are made based on available market information and judgments about the financial instrument at a specific point in time. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument. We validate prices through an investment analyst review process, which includes validation through direct interaction with external sources, review of recent trade activity or use of internal models. In circumstances

where broker quotes are used to value an instrument, we generally receive one non-binding quote. Broker quotes are validated through an investment analyst review process, which includes validation through direct interaction with external sources and use of internal models or other relevant information. We did not make any significant changes to our valuation processes during 2017.

***Fixed Maturities***

Fixed maturities include bonds, ABS, redeemable preferred stock and certain non-redeemable preferred securities. When available, the fair value of fixed maturities is based on quoted prices of identical assets in active markets. These are reflected in Level 1 and primarily include U.S. Treasury bonds and actively traded redeemable corporate preferred securities.

When quoted prices of identical assets in active markets are not available, our first priority is to obtain prices from third party pricing vendors. We have regular interaction with these vendors to ensure we understand their pricing methodologies and to confirm they are utilizing observable market information. Their methodologies vary by asset class and include inputs such as estimated cash flows, benchmark yields, reported trades, broker quotes, credit quality, industry events and economic events. Fixed maturities with validated prices from pricing services, which includes the majority of our public fixed maturities in all asset classes, are generally reflected in Level 2. Also included in Level 2 are corporate bonds when quoted market prices are not available, for which an internal model using substantially all observable inputs or a matrix pricing valuation approach is used. In the matrix approach, securities are grouped into pricing categories that vary by sector, rating and average life. Each pricing category is assigned a risk spread based on studies of observable public market data from the investment professionals assigned to specific security classes. The expected cash flows of the security are then discounted back at the current Treasury curve plus the appropriate risk spread. Although the matrix valuation approach provides a fair valuation of each pricing category, the valuation of an individual security within each pricing category may actually be impacted by company specific factors.

Table of Contents

**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**September 30, 2017**