

AMERICAN EQUITY INVESTMENT LIFE HOLDING CO
Form 10-Q
November 08, 2013

FORM 10-Q

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from _____ to _____

Commission File Number : 001-31911

American Equity Investment Life Holding Company

(Exact name of registrant as specified in its charter)

Iowa

42-1447959

(State or other jurisdiction of incorporation or
organization)

(I.R.S. Employer Identification No.)

6000 Westown Parkway

50266

West Des Moines, Iowa

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area
code

(515) 221-0002

(Telephone)

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

Title of each class

Name of each exchange on which registered

Common Stock, par value \$1

New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: Common Stock, par value \$1

Indicate by check mark whether the registrant (1) has filed all documents and reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or 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 or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

APPLICABLE TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Shares of common stock outstanding at October 31, 2013: 69,052,869

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share and per share data)

	September 30, 2013 (Unaudited)	December 31, 2012
Assets		
Investments:		
Fixed maturity securities:		
Available for sale, at fair value (amortized cost: 2013 - \$25,783,116; 2012 - \$21,957,027)	\$26,262,878	\$24,172,136
Held for investment, at amortized cost (fair value: 2013 - \$60,843; 2012 - \$61,521)	76,212	76,088
Equity securities, available for sale, at fair value (cost: 2013 - \$8,917; 2012 - \$44,598)	9,708	53,422
Mortgage loans on real estate	2,593,851	2,623,940
Derivative instruments	625,236	415,258
Other investments	212,870	196,366
Total investments	29,780,755	27,537,210
Cash and cash equivalents	934,931	1,268,545
Coinsurance deposits	2,970,601	2,910,701
Accrued investment income	307,554	261,833
Deferred policy acquisition costs	2,291,996	1,709,799
Deferred sales inducements	1,763,137	1,292,341
Deferred income taxes	225,894	—
Other assets	438,279	153,049
Total assets	\$38,713,147	\$35,133,478
Liabilities and Stockholders' Equity		
Liabilities:		
Policy benefit reserves	\$34,652,479	\$31,773,988
Other policy funds and contract claims	431,425	455,752
Notes payable	691,452	309,869
Subordinated debentures	246,003	245,869
Amounts due under repurchase agreements	148,180	—
Deferred income taxes	—	49,303
Income taxes payable	29,878	4,756
Other liabilities	1,119,062	573,704
Total liabilities	37,318,479	33,413,241
Stockholders' equity:		
Preferred stock, par value \$1 per share, 2,000,000 shares authorized, 2013 and 2012 - no shares issued and outstanding	—	—
	64,723	61,751

Common stock, par value \$1 per share, 200,000,000 shares authorized; issued and outstanding:

2013 - 64,722,600 shares (excluding 4,876,735 treasury shares);

2012 - 61,750,601 shares (excluding 5,127,379 treasury shares)

Additional paid-in capital	487,971	496,715
Unallocated common stock held by ESOP; 2013 - 186,485 shares; 2012 - 239,799 shares	(1,623	) (2,583)
Accumulated other comprehensive income	163,725	686,807
Retained earnings	679,872	477,547
Total stockholders' equity	1,394,668	1,720,237
Total liabilities and stockholders' equity	\$38,713,147	\$35,133,478

See accompanying notes to unaudited consolidated financial statements.

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2013	2012	2013	2012	
Revenues:					
Traditional life insurance premiums	\$2,493	\$3,300	\$8,104	\$9,770	
Annuity product charges	26,451	23,875	71,443	65,176	
Net investment income	354,147	318,594	1,019,980	965,763	
Change in fair value of derivatives	193,028	161,090	631,030	269,404	
Net realized gains (losses) on investments, excluding other than temporary impairment ("OTTI") losses	(2,077) (1,238) 24,197	(7,925)
OTTI losses on investments:					
Total OTTI losses	—	—	(4,964) (2,156)
Portion of OTTI losses recognized from other comprehensive income	(222) (1,686) (1,270) (3,389)
Net OTTI losses recognized in operations	(222) (1,686) (6,234) (5,545)
Loss on extinguishment of debt	(938) —	(1,527) —	
Total revenues	572,882	503,935	1,746,993	1,296,643	
Benefits and expenses:					
Insurance policy benefits and change in future policy benefits	1,647	1,865	5,488	6,232	
Interest sensitive and index product benefits	327,976	246,105	889,810	527,961	
Amortization of deferred sales inducements	34,625	7,709	183,992	50,359	
Change in fair value of embedded derivatives	36,224	188,201	(8,913	) 466,278
Interest expense on notes payable	12,957	7,141	26,985	21,208	
Interest expense on subordinated debentures	3,034	3,235	9,061	10,384	
Amortization of deferred policy acquisition costs	50,034	25,954	265,534	105,086	
Other operating costs and expenses	20,658	36,170	65,029	76,785	
Total benefits and expenses	487,155	516,380	1,436,986	1,264,293	
Income (loss) before income taxes	85,727	(12,445	) 310,007	32,350
Income tax expense (benefit)	29,546	(4,616	) 107,682	10,949
Net income (loss)	\$56,181	\$(7,829	) \$202,325	\$21,401
Earnings (loss) per common share					
Earnings (loss) per common share	\$0.86	\$(0.13	) \$3.15	\$0.35
Earnings (loss) per common share - assuming dilution	\$0.75	\$(0.13	) \$2.79	\$0.34
Weighted average common shares outstanding (in thousands):					
Earnings (loss) per common share	65,129	62,504	64,239	60,723	
Earnings (loss) per common share - assuming dilution	74,560	65,262	72,459	65,232	
See accompanying notes to unaudited consolidated financial statements.					

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Dollars in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income (loss)	\$56,181	\$(7,829)	) \$202,325	\$21,401
Other comprehensive income (loss):				
Change in net unrealized investment gains/losses (1)	(123,269)	) 202,184	(793,140)	) 390,575
Noncredit component of OTTI losses (1)	239	1,377	586	1,667
Reclassification of unrealized investment gains/losses to net income (loss) (1)	(903)	) —	(12,189)) —
Other comprehensive income (loss) before income tax	(123,933)	) 203,561	(804,743)	) 392,242
Income tax effect related to other comprehensive income (loss)	43,378	(71,247)	) 281,661	(137,285)
Other comprehensive income (loss)	(80,555)	) 132,314	(523,082)	) 254,957
Comprehensive income (loss)	\$(24,374)	) \$124,485	\$(320,757)	) \$276,358

(1) Net of related adjustments to amortization of deferred sales inducements and deferred policy acquisition costs.
See accompanying notes to unaudited consolidated financial statements.

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Dollars in thousands, except share data)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Unallocated Common Stock Held by ESOP	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders' Equity
Balance at December 31, 2012	\$61,751	\$496,715	\$(2,583)	\$ 686,807	\$477,547	\$ 1,720,237
Net income for period	—	—	—	—	202,325	202,325
Other comprehensive loss	—	—	—	(523,082)	—	(523,082)
Allocation of 89,150 shares of common stock by ESOP, including excess income tax benefits	—	432	960	—	—	1,392
Share-based compensation, including excess income tax benefits	—	7,492	—	—	—	7,492
Issuance of 2,755,270 shares of common stock under compensation plans, including excess income tax benefits	2,755	23,663	—	—	—	26,418
Extinguishment of convertible senior notes, net of tax, including 216,729 shares of common stock issued upon conversion	217	1,547	—	—	—	1,764
Warrants to be settled in cash	—	(41,878)	—	—	—	(41,878)
Balance at September 30, 2013	\$64,723	\$487,971	\$(1,623)	\$ 163,725	\$679,872	\$ 1,394,668
Balance at December 31, 2011	\$57,837	\$468,281	\$(3,620)	\$ 457,229	\$428,952	\$ 1,408,679
Net income for period	—	—	—	—	21,401	21,401
Other comprehensive income	—	—	—	254,957	—	254,957
Conversion of \$20,770 of subordinated debentures	2,564	17,027	—	—	—	19,591
Allocation of 63,946 shares of common stock by ESOP, including excess income tax benefits	—	32	689	—	—	721
Share-based compensation, including excess income tax benefits	—	5,495	—	—	—	5,495
Issuance of 1,147,440 shares of common stock under compensation plans, including excess income tax benefits	1,147	2,962	—	—	—	4,109
Balance at September 30, 2012	\$61,548	\$493,797	\$(2,931)	\$ 712,186	\$450,353	\$ 1,714,953

See accompanying notes to unaudited consolidated financial statements.

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2013	2012
Operating activities		
Net income	\$202,325	\$21,401
Adjustments to reconcile net income to net cash provided by operating activities:		
Interest sensitive and index product benefits	889,810	527,961
Amortization of deferred sales inducements	183,992	50,359
Annuity product charges	(71,443	) (65,176
Change in fair value of embedded derivatives	(8,913	) 466,278
Change in traditional life and accident and health insurance reserves	(3,925	) 27,850
Policy acquisition costs deferred	(313,560	) (287,285
Amortization of deferred policy acquisition costs	265,534	105,086
Provision for depreciation and other amortization	14,285	13,969
Amortization of discounts and premiums on investments	7,920	(75,596
Realized gains/losses on investments and net OTTI losses recognized in operations	(17,963	) 13,470
Change in fair value of derivatives	(631,030	) (269,404
Deferred income taxes	9,965	(41,469
Share-based compensation	5,942	4,907
Change in accrued investment income	(45,721	) (47,938
Change in income taxes payable	23,040	9,856
Change in other assets	(36	) (5,354
Change in other policy funds and contract claims	(24,327	) 56,568
Change in collateral held for derivatives	115,666	324,596
Change in other liabilities	5,474	3,442
Other	(2,611	) (3,873
Net cash provided by operating activities	604,424	829,648
Investing activities		
Sales, maturities, or repayments of investments:		
Fixed maturity securities - available for sale	2,955,734	1,942,533
Fixed maturity securities - held for investment	—	2,618,207
Equity securities - available for sale	44,829	7,604
Mortgage loans on real estate	402,233	341,771
Derivative instruments	662,336	276,227
Other investments	18,244	25,901
Acquisition of investments:		
Fixed maturity securities - available for sale	(6,691,800	) (4,987,848
Mortgage loans on real estate	(383,074	) (280,749
Derivative instruments	(302,135	) (280,407
Other investments	(24,302	) (83,779
Purchases of property, furniture and equipment	(621	) (378
Net cash used in investing activities	(3,318,556	) (420,918

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(Dollars in thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2013	2012
Financing activities		
Receipts credited to annuity policyholder account balances	\$3,073,490	\$2,738,553
Coinsurance deposits	20,355	(16,364)
Return of annuity policyholder account balances	(1,226,967)	(1,134,943)
Financing fees incurred and deferred	(9,045)	—
Proceeds from notes payable	415,000	—
Repayment of notes payable	(43,243)	—
Repayment of subordinated debentures	—	(270)
Proceeds from amounts due under repurchase agreements	148,180	—
Excess tax benefits realized from share-based compensation plans	1,993	624
Proceeds from issuance of common stock	25,900	4,055
Change in checks in excess of cash balance	(25,145)	(7,903)
Net cash provided by financing activities	2,380,518	1,583,752
Increase (decrease) in cash and cash equivalents	(333,614)	1,992,482
Cash and cash equivalents at beginning of period	1,268,545	404,952
Cash and cash equivalents at end of period	\$934,931	\$2,397,434
Supplemental disclosures of cash flow information		
Cash paid during period for:		
Interest expense	\$19,136	\$20,858
Income taxes	72,900	41,938
Non-cash operating activity:		
Deferral of sales inducements	(250,322)	220,784
Non-cash investing activity:		
Real estate acquired in satisfaction of mortgage loans	6,285	14,932
Non-cash financing activities:		
Conversion of subordinated debentures	—	20,770
Common stock issued in extinguishment of debt	3,367	—
Warrants to be settled in cash	41,878	—
See accompanying notes to unaudited consolidated financial statements.		

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

1. Significant Accounting Policies

Consolidation and Basis of Presentation

The accompanying consolidated financial statements of American Equity Investment Life Holding Company (“we”, “us” or “our”) have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and notes required by GAAP for complete financial statements. The consolidated financial statements reflect all adjustments, consisting only of normal recurring items, which are necessary to present fairly our financial position and results of operations on a basis consistent with the prior audited consolidated financial statements. Operating results for the three and nine month periods ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ended December 31, 2013. All significant intercompany accounts and transactions have been eliminated. The preparation of financial statements requires the use of management estimates. For further information related to a description of areas of judgment and estimates and other information necessary to understand our financial position and results of operations, refer to the audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2012. As previously reported in the notes to consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2012, we identified certain classification errors related to amounts reported in the financing activities section of our consolidated statements of cash flows. Consistent with that presentation, we have revised the consolidated statement of cash flows for the nine months ended September 30, 2012 resulting in decreases of \$140.3 million to receipts credited to annuity policyholder account balances and return of annuity policyholder account balances. These revisions had no net impact on net cash provided by financing activities, and no impact on our consolidated balance sheets, statements of operations, statements of comprehensive income or statements of changes in stockholders' equity.

Adopted Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (“FASB”) issued an accounting standards update (“ASU”) that expands the disclosure requirements related to other comprehensive income (loss). A reporting entity is now required to provide information about the amounts reclassified out of accumulated other comprehensive income (loss) by component. In addition, a reporting entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. This ASU became effective for interim and annual periods beginning after December 15, 2012. We adopted this ASU on January 1, 2013.

New Accounting Pronouncements

There are currently no accounting standards updates with effective dates after September 30, 2013 that will significantly affect our consolidated financial statements.

2. Fair Values of Financial Instruments

The following sets forth a comparison of the carrying amounts and fair values of our financial instruments:

	September 30, 2013		December 31, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
(Dollars in thousands)				
Assets				
Fixed maturity securities:				
Available for sale	\$26,262,878	\$26,262,878	\$24,172,136	\$24,172,136
Held for investment	76,212	60,843	76,088	61,521
Equity securities, available for sale	9,708	9,708	53,422	53,422
Mortgage loans on real estate	2,593,851	2,711,170	2,623,940	2,848,235
Derivative instruments	625,236	625,236	415,258	415,258
Other investments	187,437	187,655	163,193	163,517
Cash and cash equivalents	934,931	934,931	1,268,545	1,268,545
Coinsurance deposits	2,970,601	2,642,309	2,910,701	2,678,232
Interest rate caps	5,356	5,356	3,247	3,247
2015 notes hedges	144,904	144,904	43,105	43,105
Counterparty collateral	240,713	240,713	—	—
Liabilities				
Policy benefit reserves	34,319,660	28,802,302	31,452,496	26,264,831
Single premium immediate annuity (SPIA) benefit reserves	430,908	444,512	455,167	469,768
Notes payable	691,452	1,023,962	309,869	422,175
Subordinated debentures	246,003	233,125	245,869	218,283
2015 notes embedded derivatives	147,150	147,150	43,105	43,105
2015 warrants	51,077	51,077	—	—
Interest rate swap	222	222	4,261	4,261

Fair value is the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date. The objective of a fair value measurement is to determine that price for each financial instrument at each measurement date. We meet this objective using various methods of valuation that include market, income and cost approaches.

We categorize our financial instruments into three levels of fair value hierarchy based on the priority of inputs used in determining fair value. The hierarchy defines the highest priority inputs (Level 1) as quoted prices in active markets for identical assets or liabilities. The lowest priority inputs (Level 3) are our own assumptions about what a market participant would use in determining fair value such as estimated future cash flows. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, a financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument. We categorize financial assets and liabilities recorded at fair value in the consolidated balance sheets as follows:

Level 1— Quoted prices are available in active markets for identical financial instruments as of the reporting date. We do not adjust the quoted price for these financial instruments, even in situations where we hold a large position and a sale could reasonably impact the quoted price.

Level 2— Quoted prices in active markets for similar financial instruments, quoted prices for identical or similar financial instruments in markets that are not active; and models and other valuation methodologies using inputs other than quoted prices that are observable.

Level Models and other valuation methodologies using significant inputs that are unobservable for financial instruments and include situations where there is little, if any, market activity for the financial instrument. The inputs into the determination of fair value require significant management judgment or estimation. Financial instruments that are included in Level 3 are securities for which no market activity or data exists and for which we used discounted expected future cash flows with our own assumptions about what a market participant would use in determining fair value.

Transfers of securities among the levels occur at times and depend on the type of inputs used to determine fair value of each security. There were no transfers between levels during the nine months ended September 30, 2013.

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Our assets and liabilities which are measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012 are presented below based on the fair value hierarchy levels:

	Total Fair Value	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(Dollars in thousands)				
September 30, 2013				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$4,907	\$4,907	\$—	\$—
United States Government sponsored agencies	1,239,603	—	1,239,603	—
United States municipalities, states and territories	3,461,131	—	3,461,131	—
Foreign government obligations	92,682	—	92,682	—
Corporate securities	16,741,581	8,794	16,732,787	—
Residential mortgage backed securities	2,118,827	—	2,117,513	1,314
Commercial mortgage backed securities	1,590,310	—	1,590,310	—
Other asset backed securities	1,013,837	362	1,013,475	—
Equity securities, available for sale: finance, insurance and real estate	9,708	1,908	7,800	—
Derivative instruments	625,236	—	625,236	—
Cash and cash equivalents	934,931	934,931	—	—
Interest rate caps	5,356	—	5,356	—
2015 notes hedges	144,904	—	144,904	—
Counterparty collateral	240,713	—	240,713	—
	\$28,223,726	\$950,902	\$27,271,510	\$1,314
Liabilities				
2015 notes embedded derivatives	\$147,150	\$—	\$147,150	\$—
Interest rate swap	222	—	222	—
2015 warrants	51,077	—	51,077	—
Fixed index annuities - embedded derivatives	3,975,862	—	—	3,975,862
	\$4,174,311	\$—	\$198,449	\$3,975,862
December 31, 2012				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$5,154	\$5,154	\$—	\$—
United States Government sponsored agencies	1,772,025	—	1,772,025	—
United States municipalities, states and territories	3,578,323	—	3,578,323	—
Foreign government obligations	105,259	—	105,259	—
Corporate securities	14,466,772	33,131	14,433,641	—
Residential mortgage backed securities	2,888,113	—	2,886,301	1,812
Commercial mortgage backed securities	357,982	—	357,982	—
Other asset backed securities	998,508	378	998,130	—
Equity securities, available for sale: finance, insurance and real estate	53,422	36,928	16,494	—

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Derivative instruments	415,258	—	415,258	—
Cash and cash equivalents	1,268,545	1,268,545	—	—
Interest rate caps	3,247	—	3,247	—
2015 notes hedges	43,105	—	43,105	—
	\$25,955,713	\$1,344,136	\$24,609,765	\$1,812
Liabilities				
2015 notes embedded derivatives	\$43,105	\$—	\$43,105	\$—
Interest rate swap	4,261	—	4,261	—
Fixed index annuities - embedded derivatives	3,337,556	—	—	3,337,556
	\$3,384,922	\$—	\$47,366	\$3,337,556

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The following methods and assumptions were used in estimating the fair values of financial instruments during the periods presented in these consolidated financial statements.

Fixed maturity securities and equity securities

The fair values of fixed maturity securities and equity securities in an active and orderly market are determined by utilizing independent pricing services. The independent pricing services incorporate a variety of observable market data in their valuation techniques, including:

- reported trading prices,
- benchmark yields,
- broker-dealer quotes,
- benchmark securities,
- bids and offers,
- credit ratings,
- relative credit information, and
- other reference data.

The independent pricing services also take into account perceived market movements and sector news, as well as a security's terms and conditions, including any features specific to that issue that may influence risk and marketability. Depending on the security, the priority of the use of observable market inputs may change as some observable market inputs may not be relevant or additional inputs may be necessary.

The independent pricing services provide quoted market prices when available. Quoted prices are not always available due to market inactivity. When quoted market prices are not available, the third parties use yield data and other factors relating to instruments or securities with similar characteristics to determine fair value for securities that are not actively traded. We generally obtain one value from our primary external pricing service. In situations where a price is not available from this service, we may obtain further quotes or prices from additional parties as needed. In addition, for our callable United States Government sponsored agencies, we obtain multiple broker quotes and take the average of the broker prices received. Market indices of similar rated asset class spreads are considered for valuations and broker indications of similar securities are compared. Inputs used by the broker include market information, such as yield data and other factors relating to instruments or securities with similar characteristics. Valuations and quotes obtained from third party commercial pricing services are non-binding and do not represent quotes on which one may execute the disposition of the assets.

We validate external valuations at least quarterly through a combination of procedures that include the evaluation of methodologies used by the pricing services, analytical reviews and performance analysis of the prices against trends, and maintenance of a securities watch list. Additionally, as needed we utilize discounted cash flow models or perform independent valuations on a case-by-case basis using inputs and assumptions similar to those used by the pricing services. Although we do identify differences from time to time as a result of these validation procedures, we did not make any significant adjustments as of September 30, 2013 and December 31, 2012.

Mortgage loans on real estate

Mortgage loans on real estate are not measured at fair value on a recurring basis. The fair values of mortgage loans on real estate are calculated using discounted expected cash flows using current competitive market interest rates currently being offered for similar loans. The fair values of impaired mortgage loans on real estate that we have considered to be collateral dependent are based on the fair value of the real estate collateral (based on appraised values) less estimated costs to sell. The inputs utilized to determine fair value of all mortgage loans are unobservable market data (competitive market interest rates and appraised property values); therefore, fair value of mortgage loans falls into Level 3 in the fair value hierarchy.

Derivative instruments

The fair values of derivative instruments, primarily call options, are based upon the amount of cash that we will receive to settle each derivative instrument on the reporting date. These amounts are determined by our investment team using industry accepted valuation models and are adjusted for the nonperformance risk of each counterparty net of any collateral held. Inputs include market volatility and risk free interest rates and are used in income valuation techniques in arriving at a fair value for each option contract. The nonperformance risk for each counterparty is based

upon its credit default swap rate. We have no performance obligations related to the call options purchased to fund our fixed index annuity policy liabilities.

Other investments

None of the financial instruments included in other investments are measured at fair value on a recurring basis. Financial instruments included in other investments are policy loans, equity method investments and company owned life insurance (COLI). We have not attempted to determine the fair values associated with our policy loans, as we believe any differences between carrying value and the fair values afforded these instruments are immaterial to our consolidated financial position and, accordingly, the cost to provide such disclosure does not justify the benefit to be derived. The fair values of our equity method investments qualify as Level 3 fair values and were determined by calculating the present value of future cash flows discounted by a risk free rate, a risk spread and a liquidity discount. The risk spread and liquidity discount are rates determined by our investment professionals and are unobservable market inputs. The fair value of our COLI approximates the cash surrender value of the policies and falls within Level 2 of the fair value hierarchy.

Cash and cash equivalents

Amounts reported in the consolidated balance sheets for these instruments are reported at their historical cost which approximates fair value due to the nature of the assets assigned to this category.

Interest rate swap and caps

The fair values of our pay fixed/receive variable interest rate swap and interest rate caps are obtained from third parties and are determined by discounting expected future cash flows using projected LIBOR rates for the term of the swap and caps.

2015 notes hedges and warrants

The fair value of these call options has been determined by a third party who applies market observable data such as our common stock price, its dividend yield and its volatility, as well as the time to expiration of the call options to determine a fair value of the buy side of these options. Since August 26, 2013, when 50% of these call options were committed to partial unwind agreements, fair value has been determined in accordance with the terms of the unwind agreement that relies on market data. Fair value of the warrants that were committed to the partial unwind agreements has been determined in a similar manner in accordance with terms of the unwind agreements.

Counterparty collateral

Amounts reported in other assets of the consolidated balance sheets for these instruments are reported at their historical cost which approximates fair value due to the nature of the assets assigned to this category.

Policy benefit reserves, coinsurance deposits and SPIA benefit reserves

The fair values of the liabilities under contracts not involving significant mortality or morbidity risks (principally deferred annuities), are stated at the cost we would incur to extinguish the liability (i.e., the cash surrender value) as these contracts are generally issued without an annuitization date. The coinsurance deposits related to the annuity benefit reserves have fair values determined in a similar fashion. For period-certain annuity benefit contracts, the fair value is determined by discounting the benefits at the interest rates currently in effect for newly purchased immediate annuity contracts. We are not required to and have not estimated the fair value of the liabilities under contracts that involve significant mortality or morbidity risks, as these liabilities fall within the definition of insurance contracts that are exceptions from financial instruments that require disclosures of fair value. Policy benefit reserves, coinsurance deposits and SPIA benefit reserves are not measured at fair value on a recurring basis. All of the fair values presented within these categories fall within Level 3 of the fair value hierarchy as most of the inputs are unobservable market data.

Notes payable

The fair values of our senior unsecured notes and convertible senior notes are based upon pricing matrices developed by a third party pricing service when quoted market prices are not available and are categorized as Level 2 within the fair value hierarchy. Notes payable are not remeasured at fair value on a recurring basis.

Subordinated debentures

Fair values for subordinated debentures are estimated using discounted cash flow calculations based principally on observable inputs including our incremental borrowing rates, which reflect our credit rating, for similar types of borrowings with maturities consistent with those remaining for the debt being valued. These fair values are categorized as Level 2 within the fair value hierarchy. Subordinated debentures are not measured at fair value on a recurring basis.

2015 notes embedded derivatives

The fair value of this embedded derivative is determined by pricing the call options that remain outstanding after the partial unwind agreement that hedge this potential liability. The terms of the conversion premium are identical to the 2015 notes hedges that remain after the partial unwind agreement and the method of determining fair value of the call options is based upon observable market data.

Fixed index annuities - embedded derivatives

We estimate the fair value of the embedded derivative component of our fixed index annuity policy benefit reserves at each valuation date by (i) projecting policy contract values and minimum guaranteed contract values over the expected lives of the contracts and (ii) discounting the excess of the projected contract value amounts at the applicable risk free interest rates adjusted for our nonperformance risk related to those liabilities. The projections of policy contract values

are based on our best estimate assumptions for future policy growth and future policy decrements. Our best estimate assumptions for future policy growth include assumptions for the expected index credit on the next policy anniversary date which are derived from the fair values of the underlying call options purchased to fund such index credits and the expected costs of annual call options we will purchase in the future to fund index credits beyond the next policy anniversary. The projections of minimum guaranteed contract values include the same best estimate assumptions for policy decrements as were used to project policy contract values.

The following tables provide a reconciliation of the beginning and ending balances for our Level 3 assets and liabilities, which are measured at fair value on a recurring basis using significant unobservable inputs for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Available for sale securities				
Beginning balance	\$1,541	\$2,005	\$1,812	\$2,098
Principal returned	(148	) (101	) (709	) (194
Accretion of discount	(18	) 13	116	60
Total gains (losses) (realized/unrealized):				
Included in other comprehensive income (loss)	(61	) 28	95	211
Included in operations	—	(73	) —	(303
Ending balance	\$1,314	\$1,872	\$1,314	\$1,872

The Level 3 assets included in the table above are not material to our financial position, results of operations or cash flows, and it is management's opinion that the sensitivity of the inputs used in determining the fair value of these assets is not material as well.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Fixed index annuities - embedded derivatives				
Beginning balance	\$3,747,052	\$2,914,948	\$3,337,556	\$2,530,496
Premiums less benefits	372,363	229,340	1,044,756	418,845
Change in unrealized gains, net	(143,553	) 122,494	(406,450	) 317,441
Ending balance	\$3,975,862	\$3,266,782	\$3,975,862	\$3,266,782

Change in unrealized gains, net for each period in our embedded derivatives are included in change in fair value of embedded derivatives in the unaudited consolidated statements of operations.

Certain derivatives embedded in our fixed index annuity contracts are our most significant financial instrument measured at fair value that are categorized as Level 3 in the fair value hierarchy. The contractual obligations for future annual index credits within our fixed index annuity contracts are treated as a "series of embedded derivatives" over the expected life of the applicable contracts. We estimate the fair value of these embedded derivatives at each valuation date by the method described above under fixed index annuities - embedded derivatives. The projections of minimum guaranteed contract values include the same best estimate assumptions for policy decrements as were used to project policy contract values.

The most sensitive assumption in determining policy liabilities for fixed index annuities is the rates used to discount the excess projected contract values. As indicated above, the discount rate reflects our nonperformance risk. If the discount rates used to discount the excess projected contract values at September 30, 2013, were to increase by 100 basis points, the fair value of the embedded derivatives would decrease by \$255.4 million recorded through operations as a decrease in the change in fair value of embedded derivatives and there would be a corresponding decrease of \$155.2 million to our combined balance for deferred policy acquisition costs and deferred sales inducements recorded through operations as an increase in amortization of deferred policy acquisition costs and deferred sales inducements. A decrease by 100 basis points in the discount rate used to discount the excess projected contract values would increase the fair value of the embedded derivatives by \$283.6 million recorded through operations as an increase in the change in fair value of embedded derivatives and there would be a corresponding increase of \$168.8 million to our combined balance for deferred policy acquisition costs and deferred sales inducements recorded through operations as a decrease in amortization of deferred policy acquisition costs and deferred sales inducements.

3. Investments

At September 30, 2013 and December 31, 2012, the amortized cost and fair value of fixed maturity securities and equity securities were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
September 30, 2013				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$4,608	\$342	\$(43)	\$4,907
United States Government sponsored agencies	1,314,449	4,069	(78,915)	1,239,603
United States municipalities, states and territories	3,278,749	212,975	(30,593)	3,461,131
Foreign government obligations	86,109	9,365	(2,792)	92,682
Corporate securities	16,420,869	720,010	(399,298)	16,741,581
Residential mortgage backed securities	1,999,201	145,605	(25,979)	2,118,827
Commercial mortgage backed securities	1,664,541	5,194	(79,425)	1,590,310
Other asset backed securities	1,014,590	23,544	(24,297)	1,013,837
	\$25,783,116	\$1,121,104	\$(641,342)	\$26,262,878
Held for investment:				
Corporate security	\$76,212	\$—	\$(15,369)	\$60,843
Equity securities, available for sale:				
Finance, insurance, and real estate	\$8,917	\$791	\$—	\$9,708
December 31, 2012				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$4,590	\$564	\$—	\$5,154
United States Government sponsored agencies	1,763,789	11,704	(3,468)	1,772,025
United States municipalities, states and territories	3,116,678	461,770	(125)	3,578,323
Foreign government obligations	86,099	19,160	—	105,259
Corporate securities	12,930,173	1,568,223	(31,624)	14,466,772
Residential mortgage backed securities	2,743,537	172,304	(27,728)	2,888,113
Commercial mortgage backed securities	354,870	5,095	(1,983)	357,982
Other asset backed securities	957,291	44,190	(2,973)	998,508
	\$21,957,027	\$2,283,010	\$(67,901)	\$24,172,136
Held for investment:				
Corporate security	\$76,088	\$—	\$(14,567)	\$61,521
Equity securities, available for sale:				
Finance, insurance, and real estate	\$44,598	\$10,227	\$(1,403)	\$53,422

During the nine months ended September 30, 2013 and 2012, we received \$1.1 billion and \$3.8 billion, respectively, in redemption proceeds related to calls of our callable United States Government sponsored agency securities and public and private corporate bonds, of which \$2.6 billion for the nine months ended September 30, 2012, were classified as held for investment. The proceeds from these redemptions have been reinvested primarily in United States government sponsored agencies, corporate securities, residential and commercial mortgage backed securities and other asset backed securities. At September 30, 2013, 31% of our fixed income securities have call features of which 5% (\$1.3 billion) will become subject to call redemption during the next twelve months, of which \$500.0

million are U.S. Government agency securities maturing in January 2028 with 3.75% coupons. These securities are callable quarterly and a modest decline in interest rates from current levels could result in the calls being exercised on their next call date in January of 2014.

The amortized cost and fair value of fixed maturity securities at September 30, 2013, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. All of our mortgage and other asset backed securities provide for periodic payments throughout their lives and are shown below as separate lines.

	Available for sale		Held for investment	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
Due in one year or less	\$123,756	\$126,880	\$—	\$—
Due after one year through five years	853,588	958,053	—	—
Due after five years through ten years	7,379,238	7,364,750	—	—
Due after ten years through twenty years	6,226,753	6,341,286	—	—
Due after twenty years	6,521,449	6,748,935	76,212	60,843
	21,104,784	21,539,904	76,212	60,843
Residential mortgage backed securities	1,999,201	2,118,827	—	—
Commercial mortgage backed securities	1,664,541	1,590,310	—	—
Other asset backed securities	1,014,590	1,013,837	—	—
	\$25,783,116	\$26,262,878	\$76,212	\$60,843

Net unrealized gains on available for sale fixed maturity securities and equity securities reported as a separate component of stockholders' equity were comprised of the following:

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Net unrealized gains on available for sale fixed maturity securities and equity securities	\$480,553	\$2,223,933
Adjustments for assumed changes in amortization of deferred policy acquisition costs and deferred sales inducements	(263,337)	(1,201,974)
Deferred income tax valuation allowance reversal	22,534	22,534
Deferred income tax benefit	(76,025)	(357,686)
Net unrealized gains reported as accumulated other comprehensive income	\$163,725	\$686,807

The National Association of Insurance Commissioners (“NAIC”) assigns designations to fixed maturity securities. These designations range from Class 1 (highest quality) to Class 6 (lowest quality). In general, securities are assigned a designation based upon the ratings they are given by the Nationally Recognized Statistical Rating Organizations (“NRSRO’s”). The NAIC designations are utilized by insurers in preparing their annual statutory statements. NAIC Class 1 and 2 designations are considered “investment grade” while NAIC Class 3 through 6 designations are considered “non-investment grade.” Based on the NAIC designations, we had 98% of our fixed maturity portfolio rated investment grade at September 30, 2013 and December 31, 2012.

The following table summarizes the credit quality, as determined by NAIC designation, of our fixed maturity portfolio as of the dates indicated:

NAIC Designation	September 30, 2013		December 31, 2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
1	\$15,945,089	\$16,367,238	\$13,737,381	\$15,250,560
2	9,277,558	9,352,577	7,838,186	8,533,121
3	533,890	509,433	398,294	387,222
4	100,907	93,126	53,879	56,151
5	—	—	—	—
6	1,884	1,347	5,375	6,603

\$25,859,328 \$26,323,721 \$22,033,115 \$24,233,657

The following tables show our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities (consisting of 885 and 198 securities, respectively) have been in a continuous unrealized loss position, at September 30, 2013 and December 31, 2012:

	Less than 12 months		12 months or more		Total	Unrealized
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Losses
	(Dollars in thousands)					
September 30, 2013						
Fixed maturity securities:						
Available for sale:						
United States Government full faith and credit	\$977	\$(43)	\$—	\$—	\$977	\$(43)
United States Government sponsored agencies	1,130,979	(78,915)	—	—	1,130,979	(78,915)
United States municipalities, states and territories	488,260	(30,593)	—	—	488,260	(30,593)
Foreign government obligations	26,985	(2,792)	—	—	26,985	(2,792)
Corporate securities:						
Finance, insurance and real estate	1,291,001	(71,692)	119,734	(11,273)	1,410,735	(82,965)
Manufacturing, construction and mining	2,925,074	(161,188)	16,494	(2,608)	2,941,568	(163,796)
Utilities and related sectors	1,568,088	(83,013)	30,766	(2,673)	1,598,854	(85,686)
Wholesale/retail trade	336,683	(20,153)	—	—	336,683	(20,153)
Services, media and other	843,825	(44,173)	30,939	(2,525)	874,764	(46,698)
Residential mortgage backed securities	296,361	(23,605)	34,068	(2,374)	330,429	(25,979)
Commercial mortgage backed securities	1,268,293	(79,425)	—	—	1,268,293	(79,425)
Other asset backed securities	402,461	(17,914)	44,726	(6,383)	447,187	(24,297)
	\$10,578,987	\$(613,506)	\$276,727	\$(27,836)	\$10,855,714	\$(641,342)
Held for investment:						
Corporate security:						
Insurance	\$—	\$—	\$60,843	\$(15,369)	\$60,843	\$(15,369)
December 31, 2012						
Fixed maturity securities:						
Available for sale:						
United States Government sponsored agencies	\$973,728	\$(3,468)	\$—	\$—	\$973,728	\$(3,468)
United States municipalities, states and territories	24,393	(125)	—	—	24,393	(125)
Corporate securities:						
Finance, insurance and real estate	177,962	(4,126)	85,709	(8,438)	263,671	(12,564)
Manufacturing, construction and mining	426,120	(4,303)	21,975	(1,281)	448,095	(5,584)
Utilities and related sectors	221,044	(5,187)	39,224	(4,212)	260,268	(9,399)
Wholesale/retail trade	101,790	(784)	10,250	(208)	112,040	(992)
Services, media and other	264,421	(3,085)	—	—	264,421	(3,085)
	220,622	(8,679)	260,226	(19,049)	480,848	(27,728)

Residential mortgage backed securities						
Commercial mortgage backed securities	161,582	(1,983)	—	—	161,582	(1,983)
Other asset backed securities	145,238	(2,242)	26,131	(731)	171,369	(2,973)
	\$2,716,900	\$(33,982)	\$443,515	\$(33,919)	\$3,160,415	\$(67,901)
Held for investment:						
Corporate security:						
Insurance	\$—	\$—	\$61,521	\$(14,567)	\$61,521	\$(14,567)
Equity security, available for sale:						
Services	\$—	\$—	\$8,722	\$(1,403)	\$8,722	\$(1,403)

The following is a description of the factors causing the temporary unrealized losses by investment category as of September 30, 2013:

United States Government sponsored agencies: These securities are relatively long in duration; however, they are callable in less than 12 months making the value of such securities sensitive to changes in market interest rates. The timing of when some of these securities were purchased gave rise to unrealized losses at September 30, 2013.

United States municipalities, states and territories: These securities are relatively long in duration and their fair values are sensitive to changes in market interest rates. The timing of the purchase of these securities have resulted in unrealized losses at this point in time.

Foreign government obligations: The unrealized losses on these securities are due to wider spreads on the announcement of increased capital expenditures with resulting higher leverage and greater supply.

Corporate securities: The unrealized losses in these securities are due partially to the timing of purchases in 2012 and 2013. These securities carry yields less than those available at September 30, 2013 as the result of rising interest rates in the first nine months of 2013. In addition, a small number of securities have seen their credit spreads remain wide due to issuer or industry specific news while some financial and industrial sector credit spreads remain wide due to continued economic uncertainty and concerns of economic instability.

Residential mortgage backed securities: At September 30, 2013, we had no exposure to sub-prime residential mortgage backed securities. All of our residential mortgage backed securities are pools of first-lien residential mortgage loans. Substantially all of the securities that we own are in the most senior tranche of the securitization in which they are structured and are not subordinated to any other tranche. Our "Alt-A" residential mortgage backed securities are comprised of 36 securities with a total amortized cost basis of \$323.4 million and a fair value of \$340.7 million. Despite recent improvements in the capital markets, the fair values of RMBS with weaker borrower characteristics continue at prices below amortized cost. These RMBS prices will likely remain below our cost basis until the housing market is able to absorb current and future foreclosures.

Commercial mortgage backed securities: The unrealized losses in these securities are due partially to the timing of purchases in 2012 and 2013. A number of purchases made in the middle of the fourth quarter 2012 were at yields lower than what could be executed at the end of this quarter due to the increase in the treasury yield since the time of purchase. Yield spreads for commercial mortgage backed securities have narrowed but remain attractive.

Other asset backed securities: The unrealized losses in these securities are predominantly assigned to financial sector capital trust securities which have longer maturity dates and have declined in price due to prolonged stress in the financial sector. No securities in an unrealized loss position are rated below investment grade.

Approximately 94% and 75% of the unrealized losses on fixed maturity securities shown in the above table for September 30, 2013 and December 31, 2012, respectively, are on securities that are rated investment grade, defined as being the highest two NAIC designations. All of the securities with unrealized losses are current with respect to the payment of principal and interest.

Changes in net unrealized gains on investments for the three and nine months ended September 30, 2013 and 2012 are as follows:

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	2012	2012	2012	2012
	(Dollars in thousands)			
Fixed maturity securities held for investment carried at amortized cost	\$ (449	) \$ (626	) \$ (802	) \$ (12,505
Investments carried at fair value:				
Fixed maturity securities, available for sale	\$ (276,793	) \$ 402,274	\$ (1,735,347	) \$ 790,648
Equity securities, available for sale	(84	) 2,963	(8,033	) 6,600
	(276,877	) 405,237	(1,743,380	) 797,248
Adjustment for effect on other balance sheet accounts:				
Deferred policy acquisition costs and deferred sales inducements	152,944	(201,676	) 938,637	(405,006
Deferred income tax asset/liability	43,378	(71,247	) 281,661	(137,285
	196,322	(272,923	) 1,220,298	(542,291
Change in net unrealized gains on investments carried at fair value	\$ (80,555	) \$ 132,314	\$ (523,082	) \$ 254,957

Proceeds from sales of available for sale securities for the nine months ended September 30, 2013 and 2012 were \$1.2 billion and \$276.1 million, respectively. Scheduled principal repayments, calls and tenders for available for sale securities for the nine months ended September 30, 2013 and 2012 were \$1.9 billion and \$1.6 billion, respectively.

Realized gains and losses on sales are determined on the basis of specific identification of investments based on the trade date. Net realized gains (losses) on investments, excluding net OTTI losses for the three and nine months ended September 30, 2013 and 2012 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Available for sale fixed maturity securities:				
Gross realized gains	\$3,965	\$3,028	\$24,608	\$8,076
Gross realized losses	(2,096	) (180	) (5,106	) (535
	1,869	2,848	19,502	7,541
Equity securities:				
Gross realized gains	—	—	9,571	562
Other investments:				
Gain on sale of real estate	201	53	1,505	2,948
Loss on sale of real estate	(278	) —	(744) —
Impairment losses on real estate	(678	) (830	) (823	) (3,473
	(755	) (777	) (62	) (525
Mortgage loans on real estate:				
Increase in allowance for credit losses	(3,191	) (3,309	) (4,814	) (15,503
	\$(2,077	) \$(1,238	) \$24,197	) \$(7,925

Losses in 2013 were realized primarily due to strategies in place to reposition the fixed maturity security portfolio that result in improved net investment income, risk or duration profiles as they pertain to our asset liability management. One corporate issue was sold at a loss in 2013 due to the our fundamental, long-term concern with the issuer's ability to meet its future financial obligations.

We review and analyze all investments on an ongoing basis for changes in market interest rates and credit deterioration. This review process includes analyzing our ability to recover the amortized cost basis of each investment that has a fair value that is materially lower than its amortized cost and requires a high degree of management judgment and involves uncertainty. The evaluation of securities for other than temporary impairments is a quantitative and qualitative process, which is subject to risks and uncertainties.

We have a policy and process in place to identify securities that could potentially have impairments that are other than temporary. This process involves monitoring market events and other items that could impact issuers. The evaluation includes but is not limited to such factors as:

- the length of time and the extent to which the fair value has been less than amortized cost or cost;
- whether the issuer is current on all payments and all contractual payments have been made as agreed;
- the remaining payment terms and the financial condition and near-term prospects of the issuer;
 - the lack of ability to refinance due to liquidity problems in the credit market;
- the fair value of any underlying collateral;
- the existence of any credit protection available;
- our intent to sell and whether it is more likely than not we would be required to sell prior to recovery for debt securities;
 - our assessment in the case of equity securities including perpetual preferred stocks with credit deterioration that the security cannot recover to cost in a reasonable period of time;
- our intent and ability to retain equity securities for a period of time sufficient to allow for recovery;
- consideration of rating agency actions; and
- changes in estimated cash flows of mortgage and asset backed securities.

We determine whether other than temporary impairment losses should be recognized for debt and equity securities by assessing all facts and circumstances surrounding each security. Where the decline in market value of debt securities is attributable to changes in market interest rates or to factors such as market volatility, liquidity and spread widening, and we anticipate recovery of all contractual or expected cash flows, we do not consider these investments to be other than temporarily impaired because we do not intend to sell these investments and it is not more likely than not we will be required to sell these investments before a recovery of amortized cost, which may be maturity. For equity securities, we recognize an impairment charge in the period in which we do not have the intent and ability to hold the securities until recovery of cost or we determine that the security will not recover to book value within a reasonable period of time. We determine what constitutes a reasonable period of time on a security-by-security basis by considering all the evidence available to us, including the magnitude of any unrealized loss and its duration. In any event, this period does not exceed 18 months from the date of impairment for perpetual preferred securities for which there is evidence of deterioration in credit of the issuer and common equity securities. For perpetual preferred securities absent evidence of a deterioration in credit of the issuer we apply an impairment model, including an anticipated recovery period, similar to a debt security.

Other than temporary impairment losses on equity securities are recognized in operations. If we intend to sell a debt security or if it is more likely than not that we will be required to sell a debt security before recovery of its amortized cost basis, other than temporary impairment has occurred and the difference between amortized cost and fair value will be recognized as a loss in operations.

If we do not intend to sell and it is not more likely than not we will be required to sell the debt security but also do not expect to recover the entire amortized cost basis of the security, an impairment loss would be recognized in operations in the amount of the expected credit loss. We determine the amount of expected credit loss by calculating the present value of the cash flows expected to be collected discounted at each security's acquisition yield based on our consideration of whether the security was of high credit quality at the time of acquisition. The difference between the present value of expected future cash flows and the amortized cost basis of the security is the amount of credit loss recognized in operations. The remaining amount of the other than temporary impairment is recognized in other comprehensive income.

The determination of the credit loss component of a mortgage backed security is based on a number of factors. The primary consideration in this evaluation process is the issuer's ability to meet current and future interest and principal payments as contractually stated at time of purchase. Our review of these securities includes an analysis of the cash flow modeling under various default scenarios considering independent third party benchmarks, the seniority of the specific tranche within the structure of the security, the composition of the collateral and the actual default, loss severity and prepayment experience exhibited. With the input of third party assumptions for default projections, loss severity and prepayment expectations, we evaluate the cash flow projections to determine whether the security is performing in accordance with its contractual obligation.

We utilize the models from a leading structured product software specialist serving institutional investors. These models incorporate each security's seniority and cash flow structure. In circumstances where the analysis implies a potential for principal loss at some point in the future, we use the "best estimate" cash flow projection discounted at the security's effective yield at acquisition to determine the amount of our potential credit loss associated with this security. The discounted expected future cash flows equates to our expected recovery value. Any shortfall of the expected recovery when compared to the amortized cost of the security will be recorded as the credit loss component of other than temporary impairment.

The cash flow modeling is performed on a security-by-security basis and incorporates actual cash flows on the residential mortgage backed securities through the current period, as well as the projection of remaining cash flows using a number of assumptions including default rates, prepayment rates and loss severity rates. The default curves we use are tailored to the Prime or Alt-A residential mortgage backed securities that we own, which assume lower default rates and loss severity for Prime securities versus Alt-A securities. These default curves are scaled higher or lower depending on factors such as current underlying mortgage loan performance, rating agency loss projections, loan to value ratios, geographic diversity, as well as other appropriate considerations.

The following table presents the range of significant assumptions used to determine the credit loss component of other than temporary impairments we have recognized on residential mortgage backed securities for the nine months ended September 30, 2013 and 2012, which are all senior level tranches within the structure of the securities:

Sector	Vintage	Discount Rate		Default Rate		Loss Severity		
		Min	Max	Min	Max	Min	Max	
Nine months ended September 30, 2013								
Prime	2003	5.1	% 5.1	% 2	% 2	% 30	% 30	%
	2005	6.5	% 7.7	% 8	% 18	% 50	% 65	%
	2006	6.0	% 6.9	% 9	% 16	% 50	% 50	%
	2007	6.2	% 6.7	% 11	% 25	% 40	% 60	%
	2008	6.6	% 6.6	% 16	% 16	% 45	% 45	%
	2009	6.8	% 6.8	% 17	% 17	% 60	% 60	%
Alt-A	2005	5.6	% 8.7	% 15	% 81	% 2	% 65	%
	2007	6.2	% 6.9	% 38	% 52	% 60	% 65	%

Nine months ended September
30, 2012

Prime	2005	6.5	% 7.7	% 9	% 18	% 50	% 50	%
	2006	5.8	% 7.4	% 9	% 19	% 40	% 55	%
	2007	6.2	% 7.3	% 11	% 38	% 40	% 60	%
Alt-A	2005	5.6	% 8.7	% 12	% 27	% 5	% 55	%
	2006	6.0	% 6.0	% 32	% 46	% 55	% 60	%
	2007	6.2	% 7.0	% 31	% 55	% 55	% 60	%

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The determination of the credit loss component of a corporate bond (including redeemable preferred stocks) is based on the underlying financial performance of the issuer and their ability to meet their contractual obligations.

Considerations in our evaluation include, but are not limited to, credit rating changes, financial statement and ratio analysis, changes in management, significant changes in credit spreads, breaches of financial covenants and a review of the economic outlook for the industry and markets in which they trade. In circumstances where an issuer appears unlikely to meet its future obligation, or the security's price decline is deemed other than temporary, an estimate of credit loss is determined. Credit loss is calculated using default probabilities as derived from the credit default swaps markets in conjunction with recovery rates derived from independent third party analysis or a best estimate of credit loss. This credit loss rate is then incorporated into a present value calculation based on an expected principal loss in the future discounted at the yield at the date of purchase and compared to amortized cost to determine the amount of credit loss associated with the security.

In addition, for debt securities which we do not intend to sell and it is not more likely than not we will be required to sell, but our intent changes due to changes or events that could not have been reasonably anticipated, an other than temporary impairment charge is recognized. Once an impairment charge has been recorded, we then continue to review the other than temporarily impaired securities for appropriate valuation on an ongoing basis. Unrealized losses may be recognized in future periods through a charge to earnings, should we later conclude that the decline in fair value below amortized cost is other than temporary pursuant to our accounting policy described above. The use of different methodologies and assumptions to determine the fair value of investments and the timing and amount of impairments may have a material effect on the amounts presented in our consolidated financial statements.

The following table summarizes other than temporary impairments for the three and nine months ended September 30, 2013 and 2012, by asset type:

	Number of Securities	Total OTTI Losses	Portion of OTTI Losses Recognized from Other Comprehensive Income	Net OTTI Losses Recognized in Operations
(Dollars in thousands)				
Three months ended September 30, 2013				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	2	\$—	\$(222)	\$(222)
Three months ended September 30, 2012				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	4	\$—	\$(1,686)	\$(1,686)
Nine months ended September 30, 2013				
Fixed maturity securities, available for sale:				
United States Government sponsored agencies	2	\$(2,775)	\$—	\$(2,775)
Corporate securities:				
Industrial	1	(1,761)	—	(1,761)
Residential mortgage backed securities	6	—	(1,270)	(1,270)
Equity security, available for sale:				
Industrial	1	(428)	—	(428)
	10	\$(4,964)	\$(1,270)	\$(6,234)
Nine months ended September 30, 2012				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	24	\$(2,156)	\$(3,389)	\$(5,545)

Other than temporary impairments during the nine months ended September 30, 2013 on United States Government sponsored agencies were recognized as we had the intent to sell these securities as of June 30, 2013. These securities were sold during the quarter ended September 30, 2013. The other than temporary impairments were determined based on the market values of the underlying securities at June 30, 2013.

The cumulative portion of other than temporary impairments determined to be credit losses which have been recognized in operations for debt securities are summarized as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Cumulative credit loss at beginning of period	\$ (128,513	) \$ (122,954	) \$ (134,027	) \$ (119,095
Credit losses on securities for which OTTI has not previously been recognized	—	—	(4,536	) (47
Additional credit losses on securities for which OTTI has previously been recognized	(222	) (1,686	) (1,270	) (5,498
Accumulated losses on securities that were disposed of during the period	2,775	—	13,873	—
Cumulative credit loss at end of period	\$ (125,960	) \$ (124,640	) \$ (125,960	) \$ (124,640

The following table summarizes the cumulative noncredit portion of OTTI and the change in fair value since recognition of OTTI, both of which were recognized in other comprehensive income, by major type of security, for securities that are part of our investment portfolio at September 30, 2013 and December 31, 2012:

	Amortized Cost	OTTI Recognized in Other Comprehensive Income	Change in Fair Value Since OTTI was Recognized	Fair Value
	(Dollars in thousands)			
September 30, 2013				
Fixed maturity securities, available for sale:				
Corporate securities	\$—	\$—	\$32	\$32
Residential mortgage backed securities	715,871	(176,334	) 222,943	762,480
Equity securities, available for sale:				
Finance, insurance and real estate and services	1,416	—	493	1,909
	\$717,287	\$ (176,334	) \$223,468	\$764,421
December 31, 2012				
Fixed maturity securities, available for sale:				
Corporate securities	\$10,599	\$ (2,151	) \$5,676	\$14,124
Residential mortgage backed securities	855,915	(177,604	) 171,514	849,825
Equity securities, available for sale:				
Finance, insurance and real estate	9,976	—	9,668	19,644
	\$876,490	\$ (179,755	) \$186,858	\$883,593

4. Mortgage Loans on Real Estate

Our mortgage loan portfolio, summarized in the following table, totaled \$2.6 billion at September 30, 2013 and December 31, 2012, with commitments outstanding of \$81.2 million at September 30, 2013.

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Principal outstanding	\$2,625,563	\$2,658,883
Loan loss allowance	(31,118	) (34,234
Deferred prepayment fees	(594	) (709
Carrying value	\$2,593,851	\$2,623,940

The portfolio consists of commercial mortgage loans collateralized by the related properties and diversified as to property type, location and loan size. Our mortgage lending policies establish limits on the amount that can be loaned to one borrower and other criteria to attempt to reduce the risk of default. The mortgage loan portfolio is summarized by geographic region and property type as follows:

	September 30, 2013		December 31, 2012		
	Principal Outstanding	Percent	Principal Outstanding	Percent	
	(Dollars in thousands)				
Geographic distribution					
East	\$772,366	29.4	% \$732,762	27.5	%
Middle Atlantic	149,951	5.7	% 155,094	5.8	%
Mountain	353,820	13.5	% 387,599	14.6	%
New England	22,790	0.9	% 26,385	1.0	%
Pacific	316,822	12.1	% 320,982	12.1	%
South Atlantic	491,221	18.7	% 458,802	17.3	%
West North Central	358,115	13.6	% 370,168	13.9	%
West South Central	160,478	6.1	% 207,091	7.8	%
	\$2,625,563	100.0	% \$2,658,883	100.0	%
Property type distribution					
Office	\$613,050	23.4	% \$666,467	25.1	%
Medical Office	131,304	5.0	% 136,764	5.1	%
Retail	698,189	26.6	% 677,951	25.5	%
Industrial/Warehouse	664,703	25.3	% 692,637	26.1	%
Hotel	79,385	3.0	% 94,045	3.5	%
Apartment	269,817	10.3	% 219,335	8.2	%
Mixed use/other	169,115	6.4	% 171,684	6.5	%
	\$2,625,563	100.0	% \$2,658,883	100.0	%

We evaluate our mortgage loan portfolio for the establishment of a loan loss reserve by specific identification of impaired loans and the measurement of an estimated loss for each individual loan identified. A mortgage loan is impaired when it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. If we determine that the value of any specific mortgage loan is impaired, the carrying amount of the mortgage loan will be reduced to its fair value, based upon the present value of expected future cash flows from the loan discounted at the loan's effective interest rate, or the fair value of the underlying collateral less estimated costs to sell. In addition, we analyze the mortgage loan portfolio for the need of a general loan allowance for probable losses on all other loans. The amount of the general loan allowance is based upon management's evaluation of the collectability of the loan portfolio, historical loss experience, delinquencies, credit concentrations, underwriting standards and national and local economic conditions.

Our financing receivables currently consist of one portfolio segment which is our commercial mortgage loan portfolio. These are mortgage loans with collateral consisting of commercial real estate and borrowers consisting mostly of limited liability partnerships or limited liability corporations.

We have a population of mortgage loans that we have been carrying with workout terms (e.g. interest only periods, period of suspended payments, etc.) and a population of mortgage loans that have been in a delinquent status (i.e. more than 60 days past due). It is from this population that we have been recognizing some impairment loss due to nonpayment and, in some cases, eventual satisfaction of the loan by taking ownership of the collateral real estate. In most cases the fair value of the collateral less estimated costs to sell such collateral has been less than the outstanding principal amount of the mortgage loan.

We rate the mortgage loans in our portfolio based on factors such as historical operating performance, loan to value ratio and economic outlook, among others. We calculate a loss factor to apply to each rating based on historical losses we have recognized in our mortgage loan portfolio. We apply the loss factors to the total principal outstanding within

each rating category to determine an appropriate estimate of general loan loss allowance at September 30, 2013 and December 31, 2012.

The following tables present a rollforward of our specific and general valuation allowances for mortgage loans on real estate:

	Three Months Ended September 30, 2013		Three Months Ended September 30, 2012	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	\$ (21,176)	\$ (10,500)	\$ (25,445)	\$ (11,200)
Charge-offs	3,749	—	1,932	—
Recoveries	—	—	—	—
Provision for credit losses	(2,691)	(500)	(2,909)	(400)
Ending allowance balance	\$ (20,118)	\$ (11,000)	\$ (26,422)	\$ (11,600)
	Nine Months Ended September 30, 2013		Nine Months Ended September 30, 2012	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	\$ (23,134)	\$ (11,100)	\$ (23,664)	\$ (9,300)
Charge-offs	7,930	—	10,445	—
Recoveries	—	—	—	—
Provision for credit losses	(4,914)	100	(13,203)	(2,300)
Ending allowance balance	\$ (20,118)	\$ (11,000)	\$ (26,422)	\$ (11,600)

The specific allowance represents the total credit loss allowances on loans which are individually evaluated for impairment. The general allowance is the group of loans discussed above which are collectively evaluated for impairment. The following table presents the total outstanding principal of loans evaluated for impairment by basis of impairment method:

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Individually evaluated for impairment	\$ 50,055	\$ 53,110
Collectively evaluated for impairment	2,575,508	2,605,773
Total loans evaluated for impairment	\$ 2,625,563	\$ 2,658,883

Charge-offs include allowances that have been established on loans that were satisfied by taking ownership of the collateral. When the property is taken it is recorded at its fair value as a component of other investments and the mortgage loan is recorded as fully paid, with any allowance for credit loss that has been established charged off. Fair value of the real estate is determined by third party appraisal. There could be other situations that develop where we have established a larger specific loan loss allowance than is needed based on increases in the fair value of collateral supporting collateral dependent loans, or improvements in the financial position of a borrower so that a loan would become reliant on cash flows from debt service instead of dependent upon sale of the collateral. Charge-offs of the allowance would be recognized in those situations as well. We define collateral dependent loans as those mortgage loans for which we will depend on the value of the collateral real estate to satisfy the outstanding principal of the loan. During the three and nine months ended September 30, 2013, three and four mortgage loans, respectively, were satisfied by taking ownership of any real estate serving as collateral compared to two and eight mortgage loans for the same periods in 2012. The following table summarizes the activity in the real estate owned which was obtained in satisfaction of mortgage loans on real estate:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Real estate owned at beginning of period	\$ 26,609	\$ 38,390	\$ 33,172	\$ 36,821

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Real estate acquired in satisfaction of mortgage loans	5,441	2,916	6,285	14,902
Additions	52	—	532	117
Sales	(5,832	) (5,727	) (13,245	) (13,093
Impairments	(678	) (830	) (823	) (3,473
Depreciation	(159) (185) (488) (710
Real estate owned at end of period	\$25,433	\$34,564	\$25,433	\$34,564

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We analyze credit risk of our mortgage loans by analyzing all available evidence on loans that are delinquent and loans that are in a workout period.

	September 30, 2013 (Dollars in thousands)	December 31, 2012
Credit Exposure--By Payment Activity		
Performing	\$2,588,791	\$2,597,440
In workout	30,724	26,723
Collateral dependent	6,048	34,720
	\$2,625,563	\$2,658,883

Mortgage loans are considered delinquent when they become 60 days past due. When loans become 90 days past due, become collateral dependent or enter a period with no debt service payments required we place them on non-accrual status and discontinue recognizing interest income. If payments are received on a delinquent loan, interest income is recognized to the extent it would have been recognized if normal principal and interest would have been received timely. If payments are received to bring a delinquent loan back to current we will resume accruing interest income on that loan. Outstanding principal of loans in a non-accrual status at September 30, 2013 and December 31, 2012 totaled \$6.0 million and \$34.7 million, respectively.

All of our commercial mortgage loans depend on the cash flow of the borrower to be at a sufficient level to service the principal and interest payments as they come due. In general, cash inflows of the borrowers are generated by collecting monthly rent from tenants occupying space within the borrowers' properties. Our borrowers face collateral risks such as tenants going out of business, tenants struggling to make rent payments as they become due, and tenants canceling leases and moving to other locations. We have a number of loans where the real estate is occupied by a single tenant. Our borrowers sometimes face both a reduction in cash flow on their mortgage property as well as a reduction in the fair value of the real estate collateral. If borrowers are unable to replace lost rent revenue and increases in the fair value of their property do not materialize we could potentially incur more losses than what we have allowed for in our specific and general loan loss allowances.

Aging of financing receivables is summarized in the following table, with loans in a "workout" period as of the reporting date considered current if payments are current in accordance with agreed upon terms:

	30 - 59 Days	60 - 89 Days	90 Days and Over	Total Past Due	Current	Collateral Dependent Receivables	Total Financing Receivables
	(Dollars in thousands)						
Commercial Mortgage Loans							
September 30, 2013	\$—	\$—	\$—	\$—	\$2,619,515	\$6,048	\$2,625,563
December 31, 2012	\$—	\$—	\$—	\$—	\$2,624,163	\$34,720	\$2,658,883

Financing receivables summarized in the following table represent all loans that we are either not currently collecting or those we feel it is probable we will not collect all amounts due according to the contractual terms of the loan agreements (all loans that we have worked with the borrower to alleviate short-term cash flow issues, loans delinquent for more than 60 days at the reporting date, loans we have determined to be collateral dependent and loans that we have recorded specific impairments on that we feel may continue to have performance issues).

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)				
September 30, 2013					
Mortgage loans with an allowance	\$29,937	\$50,055	\$(20,118)	\$32,897	\$2,082
Mortgage loans with no related allowance	18,782	18,782	—	18,976	799

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	\$48,719	\$68,837	\$(20,118)	\$51,873	\$2,881
December 31, 2012						
Mortgage loans with an allowance	\$29,976	\$53,110	\$(23,134)	\$37,480	\$1,946
Mortgage loans with no related allowance	27,765	27,765	—		27,696	1,664
	\$57,741	\$80,875	\$(23,134)	\$65,176	\$3,610

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The loans that are categorized as "in workout" consist of loans that we have agreed to lower or no mortgage payments for a period of time while the borrowers address cash flow and/or operational issues. The key features of these workouts have been determined on a loan-by-loan basis. Most of these loans are in a period of low cash flow due to tenants vacating their space or tenants requesting rent relief during difficult economic periods. Generally, we have allowed the borrower a six month interest only period and in some cases a twelve month period of interest only. Interest only workout loans are expected to return to their regular debt service payments after the interest only period. Interest only loans that are not fully amortizing will have a larger balance at their balloon date than originally contracted. Fully amortizing loans that are in interest only periods will have larger debt service payments for their remaining term due to lost principal payments during the interest only period. In limited circumstances we have allowed borrowers to pay the principal portion of their loan payment into an escrow account that can be used for capital and tenant improvements for a period of not more than twelve months. In these situations new loan amortization schedules are calculated based on the principal not collected during this twelve month workout period and larger payments are collected for the remaining term of each loan. In all cases, original interest rate and maturity date have not been modified and we have not forgiven any principal amounts.

A Troubled Debt Restructuring ("TDR") is a situation where we have granted a concession to a borrower for economic or legal reasons related to the borrower's financial difficulties that we would not otherwise consider. A mortgage loan that has been granted new terms, including workout terms as described previously, would be considered a TDR if it meets conditions that would indicate a borrower is experiencing financial difficulty and the new terms constitute a concession on our part. We analyze all loans where we have agreed to workout terms and all loans that we have refinanced to determine if they meet the definition of a TDR. We consider the following factors in determining whether or not a borrower is experiencing financial difficulty:

- borrower is in default,
- borrower has declared bankruptcy,
- there is growing concern about the borrower's ability to continue as a going concern,
 - borrower has insufficient cash flows to service debt,
- borrower's inability to obtain funds from other sources, and
- there is a breach of financial covenants by the borrower.

If the borrower is determined to be in financial difficulty, we consider the following conditions to determine if the borrower was granted a concession:

- assets used to satisfy debt are less than our recorded investment,
- interest rate is modified,
- maturity date extension at an interest rate less than market rate,
- capitalization of interest,
- delaying principal and/or interest for a period of three months or more, and
- partial forgiveness of the balance or charge-off.

Mortgage loan workouts, refinances or restructures that are classified as TDRs are individually evaluated and measured for impairment. A summary of mortgage loans on commercial real estate with outstanding principal at September 30, 2013 and December 31, 2012 that we determined to be TDRs are as follows:

Geographic Region	Number of TDRs	Principal Balance Outstanding (Dollars in thousands)	Specific Loan Loss Allowance	Net Carrying Amount
September 30, 2013				
East	1	\$3,712	\$(949)	) \$2,763
Mountain	7	21,514	(631)	) 20,883
South Atlantic	6	10,792	(3,314)) 7,478
East North Central	1	2,219	(467)) 1,752
West North Central	1	1,938	—	1,938

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West South Central	1	1,714	(256) 1,458
	17	\$41,889	\$(5,617) \$36,272
December 31, 2012				
East	1	\$4,208	\$(1,425) \$2,783
Mountain	10	28,786	(1,702	) 27,084
South Atlantic	9	23,358	(5,047	) 18,311
East North Central	1	2,232	(467) 1,765
West North Central	3	9,466	(2,328) 7,138
	24	\$68,050	\$(10,969) \$57,081

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5. Derivative Instruments

We recognize all derivative instruments as assets or liabilities in the consolidated balance sheets at fair value. None of our derivatives qualify for hedge accounting, thus, any change in the fair value of the derivatives is recognized immediately in the consolidated statements of operations. The fair value of our derivative instruments, including derivative instruments embedded in fixed index annuity contracts, presented in the consolidated balance sheets are as follows:

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Assets		
Derivative instruments		
Call options	\$625,236	\$415,258
Other assets		
2015 notes hedges	144,904	43,105
Interest rate caps	5,356	3,247
	\$775,496	\$461,610
Liabilities		
Policy benefit reserves - annuity products		
Fixed index annuities - embedded derivatives	\$3,975,862	\$3,337,556
Other liabilities		
2015 notes embedded derivatives	147,150	43,105
2015 warrants	51,077	—
Interest rate swap	222	4,261
	\$4,174,311	\$3,384,922

The changes in fair value of derivatives included in the unaudited consolidated statements of operations are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Change in fair value of derivatives:				
Call options	\$129,428	\$160,735	\$532,282	\$280,014
2015 notes hedges	73,504	1,839	101,799	(5,573)
2015 warrants	(9,199)	—	(9,199)	—
Interest rate swap	(496)	(1,171)	4,039)	(4,319)
Interest rate caps	(209)	(313)	2,109)	(718)
	\$193,028	\$161,090	\$631,030	\$269,404
Change in fair value of embedded derivatives:				
2015 notes embedded derivatives	\$75,750	\$1,839	\$104,045	\$(5,573)
Fixed index annuities	(39,526)	186,362	(112,958)	471,851
	\$36,224	\$188,201	\$(8,913)	\$466,278

We have fixed index annuity products that guarantee the return of principal to the policyholder and credit interest based on a percentage of the gain in a specified market index. When fixed index annuity deposits are received, a portion of the deposit is used to purchase derivatives consisting of call options on the applicable market indices to fund the index credits due to fixed index annuity policyholders. Substantially all such call options are one year options purchased to match the funding requirements of the underlying policies. The call options are marked to fair value with the change in fair value included as a component of revenues. The change in fair value of derivatives includes the gains or losses recognized at the expiration of the option term or upon early termination and the changes in fair value for open positions. On the respective anniversary dates of the index policies, the index used to compute the annual

index credit is reset and we purchase new one-year call options to fund the next annual index credit. We manage the cost of these purchases through the terms of our fixed index annuities, which permit us to change caps, participation rates, and/or asset fees, subject to guaranteed minimums on each policy's anniversary date. By adjusting caps, participation rates, or asset fees, we can generally manage option costs except in cases where the contractual features would prevent further modifications.

Our strategy attempts to mitigate any potential risk of loss under these agreements through a regular monitoring process which evaluates the program's effectiveness. We do not purchase call options that would require payment or collateral to another institution and our call options do not contain counterparty credit-risk-related contingent features. We are exposed to risk of loss in the event of nonperformance by the counterparties and, accordingly, we purchase our option contracts from multiple counterparties and evaluate the creditworthiness of all counterparties prior to purchase of the contracts. All of these options have been purchased from nationally recognized financial institutions with a Standard and Poor's credit rating of A- or higher at the time of purchase and the maximum credit exposure to any single counterparty is subject to concentration limits. We also have credit support agreements that allow us to request the counterparty to provide collateral to us when the fair value of our exposure to the counterparty exceeds specified amounts.

The notional amount and fair value of our call options by counterparty and each counterparty's current credit rating are as follows:

Counterparty	Credit Rating (S&P)	Credit Rating (Moody's)	September 30, 2013		December 31, 2012	
			Notional Amount	Fair Value	Notional Amount	Fair Value
(Dollars in thousands)						
Bank of America	A	A3	\$1,273,995	\$47,681	\$568,786	\$16,533
Barclays	A	A2	2,936,023	108,872	3,463,777	103,929
BNP Paribas	A+	A2	1,481,037	45,958	2,207,097	60,301
Citibank, N.A.	A	A3	1,368,136	47,915	2,878,588	67,592
Credit Suisse	A	A1	3,886,014	116,310	936,625	21,518
Deutsche Bank	A	A2	909,823	37,627	886,688	20,787
HSBC	AA-	A1	235,430	12,415	295,520	6,539
J.P. Morgan	A+	Aa3	778,891	21,204	735,016	21,940
Morgan Stanley	A-	Baa1	2,713,249	89,525	1,590,505	40,113
Royal Bank of Canada	AA-	Aa3	298,349	5,862	—	—
Wells Fargo	AA-	Aa3	2,284,217	91,867	2,060,903	56,006
			\$18,165,164	\$625,236	\$15,623,505	\$415,258

As of September 30, 2013 and December 31, 2012, we held \$622.0 million and \$328.7 million, respectively, of cash and cash equivalents and other securities from counterparties for derivative collateral, which is included in other liabilities on our consolidated balance sheets. This derivative collateral limits the maximum amount of economic loss due to credit risk that we would incur if parties to the call options failed completely to perform according to the terms of the contracts to \$48.0 million and \$93.7 million at September 30, 2013 and December 31, 2012, respectively.

The future annual index credits on our fixed index annuities are treated as a "series of embedded derivatives" over the expected life of the applicable contract. We do not purchase call options to fund the index liabilities which may arise after the next policy anniversary date. We must value both the call options and the related forward embedded options in the policies at fair value.

We entered into an interest rate swap and interest rate caps to manage interest rate risk associated with the floating rate component on certain of our subordinated debentures. See Note 10 in our Annual Report on Form 10-K for the year ended December 31, 2012 for more information on our subordinated debentures. The terms of the interest rate swap provide that we pay a fixed rate of interest and receive a floating rate of interest. The terms of the interest rate caps limit the three month London Interbank Offered Rate ("LIBOR") to 2.50%. The interest rate swap and caps are not effective hedges under accounting guidance for derivative instruments and hedging activities. Therefore, we record the interest rate swap and caps at fair value and any net cash payments received or paid are included in the change in fair value of derivatives in the unaudited consolidated statements of operations.

Details regarding the interest rate swap are as follows:

Notional	Pay	September 30, 2013	December 31, 2012
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Maturity Date	Amount	Receive Rate	Rate	Counterparty	Fair Value (Dollars in thousands)	Fair Value
March 15, 2021	\$85,500	LIBOR	2.415	% SunTrust	\$(222)	\$(4,261)

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Details regarding the interest rate caps are as follows:

Maturity Date	Notional		Cap		Counterparty	September 30,	December 31,
	Amount	Floating Rate	Rate			2013	2012
						Fair Value	Fair Value
						(Dollars in thousands)	
July 7, 2021	\$40,000	LIBOR	2.50	%	SunTrust	\$2,697	\$1,634
July 8, 2021	12,000	LIBOR	2.50	%	SunTrust	809	490
July 29, 2021	27,000	LIBOR	2.50	%	SunTrust	1,850	1,123
	\$79,000					\$5,356	\$3,247

The interest rate swap has a forward starting date beginning in March 2014 and converts floating rates to fixed rates for seven years. The interest rate caps have a forward starting date beginning in July 2014 and cap our interest rates for seven years. As of September 30, 2013, we held \$5.2 million of cash and cash equivalents from the counterparty for derivative collateral related to the swap and caps, which is included in other liabilities on our consolidated balance sheets.

In September 2010, concurrently with the issuance of \$200.0 million principal amount of 3.5% Convertible Senior Notes Due 2015 (the "2015 notes"), we entered into hedge transactions (the "2015 notes hedges") with two counterparties whereby we have the option to receive the cash equivalent of the conversion spread on 16.0 million shares of our common stock based upon a strike price of \$12.50 per share, subject to certain conversion rate adjustments in the 2015 notes. These options expire on September 15, 2015, and must be settled in cash. The 2015 notes hedges are accounted for as derivative assets, and are included in Other assets in our Consolidated Balance Sheets.

The 2015 notes embedded conversion derivative and the 2015 notes hedges are adjusted to fair value each reporting period and unrealized gains and losses are reflected in our Consolidated Statements of Operations.

In separate transactions, we also sold warrants (the "2015 warrants") to two counterparties for the purchase of up to 16.0 million shares of our common stock at a price of \$16.00 per share. The number of shares and strike price of the warrants are subject to adjustment based on dividends we pay subsequent to selling the warrants. As of September 30, 2013, such adjustments have resulted in warrants outstanding for the purchase of up to 16.2 million shares of our common stock at a strike price of \$15.81 per share. The warrants expire on various dates from December 2015 through March 2016 and are intended to be settled in net shares. The total number of shares of common stock deliverable under the 2015 warrants is, however, currently limited to 11.6 million shares. We received \$15.6 million in cash proceeds from the sale of the 2015 warrants, which has been recorded as an increase in additional paid-in capital. Changes in the fair value of these warrants will not be recognized in our Consolidated Financial Statements as long as the instruments remain classified as equity.

On August 26, 2013, we entered into partial unwind agreements with the two counterparties to the 2015 notes hedges and the 2015 warrants. We agreed to settle 50% of both the outstanding call options (2015 notes hedges) and warrants on October 22, 2013, in net cash to be received from each counterparty. This coincides with the expiration of the exchange offer for the outstanding 2015 Notes discussed below. The agreements to settle the warrants in net cash required us to reclassify \$41.9 million from equity to a derivative liability which represents the fair value of 50% of the outstanding warrants on the day that we entered into the unwind agreements. Subsequent to the reclassification, we are required to recognize the change in fair value of these warrants committed to the unwind agreements through net income.

6. Notes Payable

On July 17, 2013, we issued \$400 million aggregate principal amount of senior unsecured notes due 2021 which bear interest at 6.625% per year and will mature on July 15, 2021. We used \$15 million of the net proceeds from the issuance to repay the entire amount outstanding under our revolving credit facility and, in October 2013, used \$127.6 million to pay the cash consideration portion of the convertible note exchange offers discussed below. We intend to use the remaining net proceeds from the notes issuance to tender for, redeem or repurchase the \$213.9 million aggregate principal amount of convertible notes that did not accept the exchange offers discussed below and are currently outstanding. The form and timing of any such activity will be dependent upon market conditions and other factors and there can be no assurance that any such transactions can be completed prior to the December 2014 call date for the 5.25% contingent convertible senior notes due December 15, 2029 (the "2029 notes") or the September 2015 maturity date for the 2015 notes.

The convertible senior notes included in notes payable are accounted for separately as a liability component and an equity component in the consolidated balance sheets. The liability component and equity component are as follows:

	September 30, 2013		December 31, 2012		
	September 2015 Notes	December 2029 Notes	September 2015 Notes	December 2029 Notes	December 2024 Notes
	(Dollars in thousands)				
Notes payable:					
Principal amount of liability component	\$ 200,000	\$ 115,839	\$ 200,000	\$ 115,839	\$ 28,243
Unamortized discount	(16,420)	(7,967)	(21,944)	(12,269)	—
Net carrying amount of liability component	\$ 183,580	\$ 107,872	\$ 178,056	\$ 103,570	\$ 28,243
Additional paid-in capital:					
Carrying amount of equity component		\$ 15,586		\$ 15,586	\$ 22,637
Amount by which the if-converted value exceeds principal	\$ 54,179	\$ 138,958	\$ —	\$ 30,382	\$ —

The discount is being amortized over the expected lives of the notes, which is December 15, 2014 for the 2029 notes and September 15, 2015 for the 2015 notes. The effective interest rates during the discount amortization periods are 8.9% and 11.9% on the 2015 notes and the 2029 notes, respectively. The interest cost recognized in operations for the convertible notes, inclusive of the coupon and amortization of the discount and debt issue costs, was \$7.1 million and \$21.1 million for the three and nine months ended September 30, 2013, respectively, and \$7.1 million and \$21.2 million for the same periods in 2012.

We are required to include the dilutive effect of the 2029 notes in our diluted earnings per share calculation. Because these notes include a mandatory cash settlement feature for the principal amount, incremental dilutive shares will only exist when the fair value of our common stock at the end of the reporting period exceeds the conversion price per share of \$9.57. At September 30, 2013 and 2012, the conversion premium of the 2029 notes was dilutive and the effect has been included in diluted earnings per share for the three and nine months ended September 30, 2013 and 2012. The 2015 notes and the 2015 notes hedges are excluded from the dilutive effect in our diluted earnings per share calculation as they are currently to be settled only in cash. At September 30, 2013, the 2015 warrants that were not assigned to the partial unwind agreement were dilutive as the average price of our common stock exceeded the \$15.81 strike price of the 2015 warrants and the effect has been included in diluted earnings per share for the three and nine months ended September 30, 2013.

On March 25, 2013, notice of mandatory redemption was issued for our 2024 notes. \$25.8 million principal amount of the convertible notes exercised their conversion rights prior to the April 30, 2013 mandatory redemption date. The holders of these notes received the principal amount of their notes in cash and the conversion premium in shares of our common stock, for which 216,729 shares were issued. The balance of the convertible notes (\$2.5 million principal amount) was redeemed for cash.

On August 23, 2013, we offered to exchange cash and, in certain circumstances, newly issued shares of our common stock, for any and all of our outstanding 2015 notes and 2029 notes. The exchange offers expired on October 21, 2013, and the results are discussed in Note 9.

In 2011, we entered into a three year \$160 million revolving line of credit agreement with seven banks. The interest rate is floating at a rate based on our election that will be equal to the alternate base rate (as defined in the credit agreement) plus the applicable margin or the adjusted LIBOR rate (as defined in the credit agreement) plus the applicable margin. We also pay a commitment fee on the available unused portion of the credit facility. The applicable margin and commitment fee rate are based on our credit rating and can change throughout the period of the credit facility. Based upon our current credit rating, the applicable margin is 2.00% for alternate base rate borrowings and 3.00% for adjusted LIBOR rate borrowings and the commitment fee is 0.50%. Under this agreement, we are required to maintain a minimum risk-based capital ratio at American Equity Life, a maximum ratio of debt to total capital, a minimum cash coverage ratio, and a minimum level of statutory surplus at American Equity Life. No amounts were outstanding at September 30, 2013 and December 31, 2012.

As part of our investment strategy, we enter into securities repurchase agreements (short-term collateralized borrowings). The maximum amount borrowed during the nine months ended September 30, 2013 was \$258.6 million. We had no borrowings under repurchase agreements during the nine months ended September 30, 2012. When we do borrow cash on these repurchase agreements, we pledge collateral in the form of debt securities with fair values approximately equal to the amount due and we use the cash to purchase debt securities ahead of the time we collect the cash from selling annuity policies to avoid a lag between the investment of funds and the obligation to credit interest to policyholders. We earn investment income on the securities purchased with these borrowings at a rate in excess of the cost of these borrowings. Such borrowings averaged \$131.5 million and \$47.5 million for the three and nine months ended September 30, 2013, respectively. The weighted average interest rate on amounts due under repurchase agreements was 0.17% and