

AMERICAN EQUITY INVESTMENT LIFE HOLDING CO

Form 10-Q

November 10, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(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, 2014

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

West Des Moines, Iowa 50266

(Address of principal executive offices, including zip code)

(515) 221-0002

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

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:

As of November 3, 2014, there were 75,597,780 shares of the registrant's common stock, \$1 par value, outstanding.

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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, 2014 (Unaudited)	December 31, 2013
Assets		
Investments:		
Fixed maturity securities:		
Available for sale, at fair value (amortized cost: 2014 - \$29,301,310; 2013 - \$26,527,730)	\$31,023,646	\$26,610,447
Held for investment, at amortized cost (fair value: 2014 - \$71,499; 2013 - \$60,840)	76,387	76,255
Equity securities, available for sale, at fair value (cost: 2014 - \$7,507; 2013 - \$7,503)	7,756	7,778
Mortgage loans on real estate	2,474,306	2,581,082
Derivative instruments	744,033	856,050
Other investments	283,924	215,042
Total investments	34,610,052	30,346,654
Cash and cash equivalents	788,800	897,529
Coinsurance deposits	3,080,282	2,999,618
Accrued investment income	340,215	301,641
Deferred policy acquisition costs	2,132,926	2,426,652
Deferred sales inducements	1,641,558	1,875,880
Deferred income taxes	76,269	301,856
Other assets	283,427	471,669
Total assets	\$42,953,529	\$39,621,499
Liabilities and Stockholders' Equity		
Liabilities:		
Policy benefit reserves	\$38,790,456	\$35,789,655
Other policy funds and contract claims	377,341	418,033
Notes payable	475,295	549,958
Subordinated debentures	246,193	246,050
Amounts due under repurchase agreements	81,189	—
Income taxes payable	3,769	10,153
Other liabilities	1,004,210	1,222,963
Total liabilities	40,978,453	38,236,812
Stockholders' equity:		
Preferred stock, par value \$1 per share, 2,000,000 shares authorized, 2014 and 2013 - no shares issued and outstanding	—	—
Common stock, par value \$1 per share, 200,000,000 shares authorized; issued and 74,270 outstanding:		70,535

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2014 - 74,269,593 shares (excluding 4,527,167 treasury shares); 2013 - 70,535,404 shares (excluding 4,876,735 treasury shares)		
Additional paid-in capital	541,882	550,400
Unallocated common stock held by ESOP; 2013 - 58,618 shares	—	(631)
Accumulated other comprehensive income	545,931	46,196
Retained earnings	812,993	718,187
Total stockholders' equity	1,975,076	1,384,687
Total liabilities and stockholders' equity	\$42,953,529	\$39,621,499
See accompanying notes to unaudited consolidated financial statements.		

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CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share data)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Revenues:				
Premiums and other considerations	\$6,043	\$9,874	\$22,497	\$34,508
Annuity product charges	31,958	26,451	86,477	71,443
Net investment income	386,931	354,147	1,127,818	1,019,980
Change in fair value of derivatives	39,218	193,028	358,594	631,030
Net realized gains (losses) on investments, excluding other than temporary impairment ("OTTI") losses	(3,190	) (2,077	) (6,134	) 24,197
OTTI losses on investments:				
Total OTTI losses	—	—	—	(4,964
Portion of OTTI losses recognized from other comprehensive income	(564	) (222	) (2,063	) (1,270
Net OTTI losses recognized in operations	(564	) (222	) (2,063	) (6,234
Loss on extinguishment of debt	—	(938	) (10,551	) (1,527
Total revenues	460,396	580,263	1,576,638	1,773,397
Benefits and expenses:				
Insurance policy benefits and change in future policy benefits	9,109	11,264	30,191	39,792
Interest sensitive and index product benefits	429,415	325,740	1,114,381	881,910
Amortization of deferred sales inducements	40,661	34,625	96,676	183,992
Change in fair value of embedded derivatives	(195,206	) 36,224	(21,652	) (8,913
Interest expense on notes payable	8,741	12,957	28,126	26,985
Interest expense on subordinated debentures	3,044	3,034	9,076	9,061
Amortization of deferred policy acquisition costs	39,671	50,034	113,949	265,534
Other operating costs and expenses	20,616	20,658	60,588	65,029
Total benefits and expenses	356,051	494,536	1,431,335	1,463,390
Income before income taxes	104,345	85,727	145,303	310,007
Income tax expense	36,530	29,546	50,497	107,682
Net income	\$67,815	\$56,181	\$94,806	\$202,325
Earnings per common share				
Earnings per common share	\$0.90	\$0.86	\$1.28	\$3.15
Earnings per common share - assuming dilution	\$0.85	\$0.75	\$1.19	\$2.79
Weighted average common shares outstanding (in thousands):				
Earnings per common share	75,083	65,129	74,030	64,239
Earnings per common share - assuming dilution	79,467	74,560	79,477	72,459
See accompanying notes to unaudited consolidated financial statements.				

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Dollars in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	\$67,815	\$56,181	\$94,806	\$202,325
Other comprehensive income (loss):				
Change in net unrealized investment gains/losses (1)	(15,590)	(123,269)	768,414	(793,140)
Noncredit component of OTTI losses (1)	9	239	703	586
Reclassification of unrealized investment gains/losses to net income (1)	(18)	(903)	(294)	(12,189)
Other comprehensive income (loss) before income tax	(15,599)	(123,933)	768,823	(804,743)
Income tax effect related to other comprehensive income (loss)	5,459	43,378	(269,088)	281,661
Other comprehensive income (loss)	(10,140)	(80,555)	499,735	(523,082)
Comprehensive income (loss)	\$57,675	\$(24,374)	\$594,541	\$(320,757)

(1) Net of related adjustments to amortization of deferred sales inducements and deferred policy acquisition costs.

See accompanying notes to unaudited consolidated financial statements.

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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, 2013	\$70,535	\$550,400	\$(631)	\$ 46,196	\$718,187	\$ 1,384,687
Net income for period	—	—	—	—	94,806	94,806
Other comprehensive income	—	—	—	499,735	—	499,735
Allocation of 58,618 shares of common stock by ESOP, including excess income tax benefits	—	721	631	—	—	1,352
Share-based compensation, including excess income tax benefits	—	4,548	—	—	—	4,548
Issuance of 1,290,732 shares of common stock under compensation plans, including excess income tax benefits	1,291	9,653	—	—	—	10,944
Extinguishment of convertible senior notes, net of tax, including 2,443,457 shares of common stock issued upon conversion	2,444	7,015	—	—	—	9,459
Warrants settled in cash	—	(30,455)	—	—	—	(30,455)
Balance at September 30, 2014	\$74,270	\$541,882	\$—	\$ 545,931	\$812,993	\$ 1,975,076
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

See accompanying notes to unaudited consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Nine Months Ended	
	September 30,	
	2014	2013
Operating activities		
Net income	\$94,806	\$202,325
Adjustments to reconcile net income to net cash provided by operating activities:		
Interest sensitive and index product benefits	1,114,381	881,910
Amortization of deferred sales inducements	96,676	183,992
Annuity product charges	(86,477)	) (71,443)
Change in fair value of embedded derivatives	(21,652)	) (8,913)
Change in traditional life and accident and health insurance reserves	396	11,327
Policy acquisition costs deferred	(312,070)	) (313,560)
Amortization of deferred policy acquisition costs	113,949	265,534
Provision for depreciation and other amortization	7,578	14,285
Amortization of discounts and premiums on investments	(12,500)	) 7,920
Realized gains/losses on investments and net OTTI losses recognized in operations	8,197	(17,963)
Change in fair value of derivatives	(359,626)	) (631,030)
Deferred income taxes	(39,823)	) 9,965
Loss on extinguishment of debt	10,551	589
Share-based compensation	1,142	5,942
Change in accrued investment income	(38,574)	) (45,721)
Change in income taxes recoverable/payable	(6,384)	) 23,040
Change in other assets	(2,359)	) (36)
Change in other policy funds and contract claims	(47,257)	) (31,679)
Change in collateral held for derivatives	10,048	115,666
Change in other liabilities	(40,310)	) 5,474
Other	(3,339)	) (3,200)
Net cash provided by operating activities	487,353	604,424
Investing activities		
Sales, maturities, or repayments of investments:		
Fixed maturity securities - available for sale	1,233,408	2,955,734
Equity securities - available for sale	—	44,829
Mortgage loans on real estate	316,841	402,233
Derivative instruments	886,556	662,336
Other investments	16,515	18,244
Acquisition of investments:		
Fixed maturity securities - available for sale	(3,998,902)	) (6,691,800)
Mortgage loans on real estate	(227,244)	) (383,074)
Derivative instruments	(355,473)	) (302,135)
Other investments	(68,891)	) (24,302)
Purchases of property, furniture and equipment	(777)) (621)
Net cash used in investing activities	(2,197,967)) (3,318,556)

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CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Dollars in thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
Financing activities		
Receipts credited to annuity and single premium universal life policyholder account balances	\$3,016,856	\$3,073,490
Coinsurance deposits	41,740	20,355
Return of annuity policyholder account balances	(1,410,682	) (1,226,967
Financing fees incurred and deferred	(100	) (9,045
Proceeds from notes payable	—	415,000
Repayment of notes payable	(119,677	) (43,243
Net proceeds from settlement of notes hedges and warrants	10,401	—
Proceeds from amounts due under repurchase agreements	81,189	148,180
Excess tax benefits realized from share-based compensation plans	4,312	1,993
Proceeds from issuance of common stock	10,038	25,900
Change in checks in excess of cash balance	(32,192	) (25,145
Net cash provided by financing activities	1,601,885	2,380,518
Decrease in cash and cash equivalents	(108,729	) (333,614
Cash and cash equivalents at beginning of period	897,529	1,268,545
Cash and cash equivalents at end of period	\$788,800	\$934,931
Supplemental disclosures of cash flow information		
Cash paid during period for:		
Interest expense	\$39,090	\$19,136
Income taxes	91,675	72,900
Non-cash operating activity:		
Deferral of sales inducements	241,277	250,322
Non-cash investing activity:		
Real estate acquired in satisfaction of mortgage loans	11,755	6,285
Non-cash financing activities:		
Common stock issued in extinguishment of debt	56,292	3,367
Warrants to be settled in cash	—	41,878
See accompanying notes to unaudited consolidated financial statements.		

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AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(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, 2014 are not necessarily indicative of the results that may be expected for the year ended December 31, 2014. 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, 2013. As previously reported in the notes to audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013, we identified certain classification errors related to the presentation of premiums and other considerations, insurance policy benefits and change in future policy benefits and interest sensitive and index product benefits related to life contingent immediate annuities in our audited consolidated statements of operations. Consistent with that presentation, we have revised the unaudited consolidated statements of operations for the three and nine months ended September 30, 2013. The changes resulted in increases to premiums and other considerations of \$7.4 million and \$26.4 million and insurance policy benefits and change in future policy benefits of \$9.6 million and \$34.3 million, as well as decreases to interest sensitive and index product benefits of \$2.2 million and \$7.9 million for the three and nine months ended September 30, 2013, respectively. These changes had no impact on the consolidated balance sheets, net income or stockholders' equity.

Reclassifications have been made to prior period unaudited consolidated financial statements to conform to the September 30, 2014 presentation.

Adopted Accounting Pronouncements

There were no accounting pronouncements that were adopted during the current period.

New Accounting Pronouncements

In June 2014, the Financial Accounting Standards Board ("FASB") issued an accounting standards update ("ASU") that requires that a performance target in a share based payment arrangement that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. This ASU will be effective for us on January 1, 2016, and early adoption is permitted, but it is not expected to have a material impact on our consolidated financial statements.

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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, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
(Dollars in thousands)				
Assets				
Fixed maturity securities:				
Available for sale	\$31,023,646	\$31,023,646	\$26,610,447	\$26,610,447
Held for investment	76,387	71,499	76,255	60,840
Equity securities, available for sale	7,756	7,756	7,778	7,778
Mortgage loans on real estate	2,474,306	2,536,716	2,581,082	2,615,410
Derivative instruments	744,033	744,033	856,050	856,050
Other investments	261,590	267,414	192,198	193,343
Cash and cash equivalents	788,800	788,800	897,529	897,529
Coinsurance deposits	3,080,282	2,733,971	2,999,618	2,669,432
Interest rate caps	3,644	3,644	6,103	6,103
Interest rate swap	—	—	712	712
2015 notes hedges	39,061	39,061	107,041	107,041
Counterparty collateral	198,434	198,434	315,824	315,824
Liabilities				
Policy benefit reserves	38,453,572	32,240,023	35,453,166	29,670,827
Single premium immediate annuity (SPIA) benefit reserves	376,980	389,508	417,625	430,835
Notes payable	475,295	546,548	549,958	699,435
Subordinated debentures	246,193	238,530	246,050	234,959
Amounts due under repurchase agreements	81,189	81,189	—	—
2015 notes embedded conversion derivative	39,061	39,061	107,041	107,041
Interest rate swap	1,252	1,252	—	—

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.

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 Level inputs into the determination of fair value require significant management judgment or estimation. Financial 3— 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 any period presented.

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Our assets and liabilities which are measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013 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, 2014				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$37,711	\$4,204	\$33,507	\$—
United States Government sponsored agencies	1,331,076	—	1,331,076	—
United States municipalities, states and territories	3,608,592	—	3,608,592	—
Foreign government obligations	192,519	—	192,519	—
Corporate securities	20,516,410	25	20,516,385	—
Residential mortgage backed securities	1,802,186	—	1,801,660	526
Commercial mortgage backed securities	2,618,928	—	2,618,928	—
Other asset backed securities	916,224	372	915,852	—
Equity securities, available for sale: finance, insurance and real estate	7,756	—	7,756	—
Derivative instruments	744,033	—	744,033	—
Cash and cash equivalents	788,800	788,800	—	—
Interest rate caps	3,644	—	3,644	—
2015 notes hedges	39,061	—	39,061	—
Counterparty collateral	198,434	—	198,434	—
	\$32,805,374	\$793,401	\$32,011,447	\$526
Liabilities				
2015 notes embedded conversion derivative	\$39,061	\$—	\$39,061	\$—
Interest rate swap	1,252	—	1,252	—
Fixed index annuities - embedded derivatives	5,261,554	—	—	5,261,554
	\$5,301,867	\$—	\$40,313	\$5,261,554
December 31, 2013				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$42,925	\$4,805	\$38,120	\$—
United States Government sponsored agencies	1,194,289	—	1,194,289	—
United States municipalities, states and territories	3,306,743	—	3,306,743	—
Foreign government obligations	91,557	—	91,557	—
Corporate securities	17,233,037	20	17,233,017	—
Residential mortgage backed securities	1,971,960	—	1,970,584	1,376
Commercial mortgage backed securities	1,735,460	—	1,735,460	—
Other asset backed securities	1,034,476	359	1,034,117	—
Equity securities, available for sale: finance, insurance and real estate	7,778	—	7,778	—
Derivative instruments	856,050	—	856,050	—

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Cash and cash equivalents	897,529	897,529	—	—
Interest rate caps	6,103	—	6,103	—
Interest rate swap	712	—	712	—
2015 notes hedges	107,041	—	107,041	—
Counterparty collateral	315,824	—	315,824	—
	\$28,801,484	\$902,713	\$27,897,395	\$1,376
Liabilities				
2015 notes embedded conversion derivative	\$107,041	\$—	\$107,041	\$—
Fixed index annuities - embedded derivatives	4,406,163	—	—	4,406,163
	\$4,513,204	\$—	\$107,041	\$4,406,163

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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, 2014 and December 31, 2013.

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 expect to 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.

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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 caps and swap

The fair values of our pay fixed/receive variable interest rate swap and our 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 caps and swap.

2015 notes hedges

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.

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 conversion derivative

The fair value of this embedded derivative is determined by pricing the call options that hedge this potential liability. The terms of the conversion option are identical to the 2015 notes hedges 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.

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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, 2014 and 2013:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(Dollars in thousands)			
Available for sale securities				
Beginning balance	\$668	\$1,541	\$1,376	\$1,812
Principal returned	(68	) (148	) (260	) (709
Amortization of premium/accretion of discount	1	(18	) (164	) 116
Total gains (losses) (realized/unrealized):				
Included in other comprehensive income (loss)	127	(61	) (19	) 95
Included in operations	(202	) —	(407) —
Ending balance	\$526	\$1,314	\$526	\$1,314

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, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(Dollars in thousands)			
Fixed index annuities - embedded derivatives				
Beginning balance	\$5,119,823	\$3,747,052	\$4,406,163	\$3,337,556
Premiums less benefits	496,295	372,363	1,294,024	1,044,756
Change in fair value, net	(354,564	) (143,553	) (438,633	) (406,450
Ending balance	\$5,261,554	\$3,975,862	\$5,261,554	\$3,975,862

Change in fair value, 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 instruments 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, 2014, were to increase by 100 basis points, the fair value of the embedded derivatives would decrease by \$355.9 million recorded through operations as a decrease in the change in fair value of embedded derivatives and there would be a corresponding decrease of \$213.9 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 \$397.8 million recorded through operations as an increase in the change in fair value of embedded derivatives and there would be a corresponding increase of \$231.6 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.

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3. Investments

At September 30, 2014 and December 31, 2013, 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, 2014				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$37,910	\$291	\$(490)	) \$37,711
United States Government sponsored agencies	1,338,476	24,207	(31,607)	) 1,331,076
United States municipalities, states and territories	3,266,015	346,044	(3,467)	) 3,608,592
Foreign government obligations	181,123	13,109	(1,713)	) 192,519
Corporate securities	19,316,396	1,334,353	(134,339)	) 20,516,410
Residential mortgage backed securities	1,684,196	129,298	(11,308)	) 1,802,186
Commercial mortgage backed securities	2,594,756	43,292	(19,120)	) 2,618,928
Other asset backed securities	882,438	38,971	(5,185)	) 916,224
	\$29,301,310	\$1,929,565	\$(207,229)	) \$31,023,646
Held for investment:				
Corporate security	\$76,387	\$—	\$(4,888)	) \$71,499
Equity securities, available for sale:				
Finance, insurance, and real estate	\$7,507	\$249	\$—	) \$7,756
December 31, 2013				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	\$44,852	\$367	\$(2,294)	) \$42,925
United States Government sponsored agencies	1,313,776	1,875	(121,362)	) 1,194,289
United States municipalities, states and territories	3,181,032	164,785	(39,074)	) 3,306,743
Foreign government obligations	86,112	8,907	(3,462)	) 91,557
Corporate securities	17,142,118	606,948	(516,029)	) 17,233,037
Residential mortgage backed securities	1,895,913	119,230	(43,183)	) 1,971,960
Commercial mortgage backed securities	1,821,988	3,287	(89,815)	) 1,735,460
Other asset backed securities	1,041,939	23,300	(30,763)	) 1,034,476
	\$26,527,730	\$928,699	\$(845,982)	) \$26,610,447
Held for investment:				
Corporate security	\$76,255	\$—	\$(15,415)	) \$60,840
Equity securities, available for sale:				
Finance, insurance, and real estate	\$7,503	\$275	\$—	) \$7,778

At September 30, 2014, 32% of our fixed income securities have call features, of which 0.8% (\$0.2 billion) were subject to call redemption and another 4% (\$1.0 billion) will become subject to call redemption during the next twelve months. \$0.5 billion of U.S. Government sponsored agency securities were called during April 2014.

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The amortized cost and fair value of fixed maturity securities at September 30, 2014, 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	\$48,059	\$49,602	\$—	\$—
Due after one year through five years	1,246,185	1,402,686	—	—
Due after five years through ten years	8,461,914	8,657,273	—	—
Due after ten years through twenty years	6,962,630	7,443,830	—	—
Due after twenty years	7,421,132	8,132,917	76,387	71,499
	24,139,920	25,686,308	76,387	71,499
Residential mortgage backed securities	1,684,196	1,802,186	—	—
Commercial mortgage backed securities	2,594,756	2,618,928	—	—
Other asset backed securities	882,438	916,224	—	—
	\$29,301,310	\$31,023,646	\$76,387	\$71,499

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, 2014	December 31, 2013
	(Dollars in thousands)	
Net unrealized gains on available for sale fixed maturity securities and equity securities	\$1,722,585	\$82,992
Adjustments for assumed changes in amortization of deferred policy acquisition costs and deferred sales inducements	(917,358)	(46,588)
Deferred income tax valuation allowance reversal	22,534	22,534
Deferred income tax expense	(281,830)	(12,742)
Net unrealized gains reported as accumulated other comprehensive income	\$545,931	\$46,196

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, 2014 and December 31, 2013.

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, 2014		December 31, 2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
1	\$18,639,433	\$19,873,945	\$16,394,654	\$16,531,250
2	10,160,844	10,657,187	9,630,251	9,598,399
3	508,843	496,899	502,822	474,165
4	67,643	66,563	74,493	66,078
5	—	—	—	—
6	934	551	1,765	1,395

\$29,377,697

\$31,095,145

\$26,603,985

\$26,671,287

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The following table shows our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities (consisting of 628 and 1,047 securities, respectively) have been in a continuous unrealized loss position, at September 30, 2014 and December 31, 2013:

	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, 2014						
Fixed maturity securities:						
Available for sale:						
United States Government full faith and credit	\$506	\$—	\$32,815	\$(490)	\$33,321	\$(490)
United States Government sponsored agencies	51,590	(380)	605,930	(31,227)	657,520	(31,607)
United States municipalities, states and territories	75,487	(644)	71,363	(2,823)	146,850	(3,467)
Foreign government obligations	15,057	(214)	12,937	(1,499)	27,994	(1,713)
Corporate securities:						
Finance, insurance and real estate	530,312	(6,352)	451,461	(20,971)	981,773	(27,323)
Manufacturing, construction and mining	1,451,461	(22,991)	839,113	(35,082)	2,290,574	(58,073)
Utilities and related sectors	387,420	(5,086)	461,882	(21,632)	849,302	(26,718)
Wholesale/retail trade	192,142	(3,723)	99,888	(5,437)	292,030	(9,160)
Services, media and other	284,105	(3,662)	260,985	(9,403)	545,090	(13,065)
Residential mortgage backed securities	148,490	(2,407)	204,929	(8,901)	353,419	(11,308)
Commercial mortgage backed securities	858,538	(7,695)	429,678	(11,425)	1,288,216	(19,120)
Other asset backed securities	48,967	(2,007)	81,296	(3,178)	130,263	(5,185)
	\$4,044,075	\$(55,161)	\$3,552,277	\$(152,068)	\$7,596,352	\$(207,229)
Held for investment:						
Corporate security:						
Insurance	\$—	\$—	\$71,499	\$(4,888)	\$71,499	\$(4,888)
December 31, 2013						
Fixed maturity securities:						
Available for sale:						
United States Government full faith and credit	\$32,969	\$(2,294)	\$—	\$—	\$32,969	\$(2,294)
United States Government sponsored agencies	692,320	(88,671)	467,309	(32,691)	1,159,629	(121,362)
United States municipalities, states and territories	614,056	(39,074)	—	—	614,056	(39,074)
Foreign government obligations	26,298	(3,462)	—	—	26,298	(3,462)
Corporate securities:						
Finance, insurance and real estate	1,690,846	(92,426)	153,037	(12,873)	1,843,883	(105,299)
Manufacturing, construction and mining	3,370,775	(191,245)	93,608	(16,088)	3,464,383	(207,333)
Utilities and related sectors	1,829,868	(102,758)	83,550	(11,547)	1,913,418	(114,305)

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Wholesale/retail trade	428,407	(25,189)	17,687	(1,992)	446,094	(27,181)
Services, media and other	834,699	(51,508)	107,242	(10,403)	941,941	(61,911)
Residential mortgage backed securities	309,599	(41,080)	31,739	(2,103)	341,338	(43,183)
Commercial mortgage backed securities	1,450,143	(83,814)	51,099	(6,001)	1,501,242	(89,815)
Other asset backed securities	356,018	(20,426)	92,372	(10,337)	448,390	(30,763)
	\$11,635,998	\$(741,947)	\$1,097,643	\$(104,035)	\$12,733,641	\$(845,982)
Held for investment:						
Corporate security:						
Insurance	\$—	\$—	\$60,840	\$(15,415)	\$60,840	\$(15,415)

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The following is a description of the factors causing the temporary unrealized losses by investment category as of September 30, 2014:

United States Government sponsored agencies: These securities are relatively long in duration; however, most 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, 2014.

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.

Corporate securities: The unrealized losses in these securities are due partially to the timing of purchases. These securities carry yields less than those available at September 30, 2014. 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, 2014, 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 35 securities with a total amortized cost basis of \$254.3 million and a fair value of \$281.6 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. A number of purchases 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.

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 89% and 95% of the unrealized losses on fixed maturity securities shown in the above table for September 30, 2014 and December 31, 2013, 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, 2014 and 2013 are as follows:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2014	2013
	(Dollars in thousands)			
Fixed maturity securities held for investment carried at amortized cost	\$4,883	\$(449)	) \$10,527	\$(802)
Investments carried at fair value:				
Fixed maturity securities, available for sale	\$(54,291)	) \$(276,793)	) \$1,639,619	\$(1,735,347)
Equity securities, available for sale	(7)	) (84)	) (26)	) (8,033)
	(54,298)	) (276,877)	) 1,639,593	(1,743,380)
Adjustment for effect on other balance sheet accounts:				
Deferred policy acquisition costs and deferred sales inducements	38,699	152,944	(870,770)	) 938,637
Deferred income tax asset/liability	5,459	43,378	(269,088)	) 281,661
	44,158	196,322	(1,139,858)	) 1,220,298
Change in net unrealized gains on investments carried at fair value	\$(10,140)	) \$(80,555)	) \$499,735	\$(523,082)

Proceeds from sales of available for sale securities for the nine months ended September 30, 2014 and 2013 were \$141.8 million and \$1.2 billion, respectively. Scheduled principal repayments, calls and tenders for available for sale securities for the nine months ended September 30, 2014 and 2013 were \$1.1 billion and \$1.9 billion, respectively.

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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, 2014 and 2013, are as follows:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(Dollars in thousands)			
Available for sale fixed maturity securities:				
Gross realized gains	\$ 179	\$ 3,965	\$ 1,536	\$ 24,608
Gross realized losses	(148	) (2,096	) (910	) (5,106
	31	1,869	626	19,502
Available for sale equity securities:				
Gross realized gains	—	—	—	9,571
Other investments:				
Gain on sale of real estate	455	201	1,493	1,505
Loss on sale of real estate	—	(278	) (231	) (744
Impairment losses on real estate	(1,436	) (678	) (2,235	) (823
	(981	) (755	) (973	) (62
Mortgage loans on real estate:				
Increase in allowance for credit losses	(2,240	) (3,191	) (5,787	) (4,814
	\$ (3,190	) \$ (2,077	) \$ (6,134	) \$ 24,197

Losses on available for sale fixed maturity securities were realized primarily due to strategies 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.

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 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 fair 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. 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.

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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 (loss).

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, 2014 and 2013, 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, 2014								
Prime	2005	7.5	% 7.5	% 15	% 15	% 50	% 50	%
	2006	6.5	% 7.4	% 11	% 12	% 50	% 50	%
	2007	7.0	% 7.0	% 14	% 14	% 55	% 55	%
Alt-A	2005	5.6	% 6.4	% 87	% 89	% 2	% 2	%
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	%

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.

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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, 2014 and 2013, 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, 2014				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	3	\$—	\$(564)	\$(564)
Three months ended September 30, 2013				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	2	\$—	\$(222)	\$(222)
Nine months ended September 30, 2014				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	6	\$—	\$(2,063)	\$(2,063)
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)

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,	
	2014	2013	2014	2013
(Dollars in thousands)				
Cumulative credit loss at beginning of period	\$(127,459)	\$(128,513)	\$(125,960)	\$(134,027)
Credit losses on securities for which OTTI has not previously been recognized	—	—	—	(4,536)
	(564)	(222)	(2,063)	(1,270)

Additional credit losses on securities for which
OTTI has previously been recognized

Accumulated losses on securities that were disposed of during the period	—	2,775	—	13,873
Cumulative credit loss at end of period	\$(128,023) \$(125,960) \$(128,023) \$(125,960)

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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 (loss), by major type of security, for securities that are part of our investment portfolio at September 30, 2014 and December 31, 2013:

	Amortized Cost	OTTI Recognized in Other Comprehensive Income	Change in Fair Value Since OTTI was Recognized	Fair Value
(Dollars in thousands)				
September 30, 2014				
Fixed maturity securities, available for sale:				
Corporate securities	\$—	\$—	\$25	\$25
Residential mortgage backed securities	597,409	(174,271)	217,197	640,335
	\$597,409	\$(174,271)	\$217,222	\$640,360
December 31, 2013				
Fixed maturity securities, available for sale:				
Corporate securities	\$—	\$—	\$20	\$20
Residential mortgage backed securities	679,265	(176,334)	216,061	718,992
	\$679,265	\$(176,334)	\$216,081	\$719,012

4. Mortgage Loans on Real Estate

Our mortgage loan portfolio, summarized in the following table, totaled \$2.5 billion at September 30, 2014 and \$2.6 billion at December 31, 2013, with commitments outstanding of \$55.9 million at September 30, 2014.

	September 30, 2014	December 31, 2013
(Dollars in thousands)		
Principal outstanding	\$2,502,703	\$2,607,698
Loan loss allowance	(27,864)	(26,047)
Deferred prepayment fees	(533)	(569)
Carrying value	\$2,474,306	\$2,581,082

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, 2014		December 31, 2013		
	Principal	Percent	Principal	Percent	
(Dollars in thousands)					
Geographic distribution					
East	\$751,859	30.0	% \$765,717	29.4	%
Middle Atlantic	143,949	5.8	% 156,489	6.0	%
Mountain	307,393	12.3	% 356,246	13.7	%
New England	14,415	0.6	% 21,324	0.8	%
Pacific	290,794	11.6	% 317,431	12.2	%
South Atlantic	490,945	19.6	% 483,852	18.5	%
West North Central	335,124	13.4	% 351,794	13.5	%
West South Central	168,224	6.7	% 154,845	5.9	%
	\$2,502,703	100.0	% \$2,607,698	100.0	%
Property type distribution					
Office	\$517,387	20.7	% \$590,414	22.6	%
Medical Office	93,834	3.7	% 125,703	4.8	%

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Retail	719,554	28.7	% 711,364	27.3	%
Industrial/Warehouse	675,131	27.0	% 673,449	25.8	%
Hotel	34,615	1.4	% 61,574	2.4	%
Apartment	332,694	13.3	% 291,823	11.2	%
Mixed use/other	129,488	5.2	% 153,371	5.9	%
	\$2,502,703	100.0	% \$2,607,698	100.0	%

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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 evaluate our mortgage loan portfolio for the establishment of a loan loss allowance 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 on a quantitative and qualitative basis. 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.

We rate each of 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. We also assess the portfolio qualitatively and apply a loss rate to all loans without a specific allowance based on management's assessment of economic conditions, and we apply an additional amount of loss allowance to a group of loans that we have identified as having higher risk of loss.

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

	Three Months Ended September 30, 2014		Three Months Ended September 30, 2013	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	\$ (17,282	) \$ (9,300	) \$ (21,176	) \$ (10,500
Charge-offs	958	—	3,749	—
Change in provision for credit losses	(1,040	) (1,200	) (2,691	) (500
Ending allowance balance	\$ (17,364	) \$ (10,500	) \$ (20,118	) \$ (11,000

	Nine Months Ended September 30, 2014		Nine Months Ended September 30, 2013	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	\$ (16,847	) \$ (9,200	) \$ (23,134	) \$ (11,100
Charge-offs	3,715	—	7,930	—
Recoveries	255	—	—	—
Change in provision for credit losses	(4,487	) (1,300	) (4,914	) 100
Ending allowance balance	\$ (17,364	) \$ (10,500	) \$ (20,118	) \$ (11,000

The specific allowance represents the total credit loss allowances on loans which are individually evaluated for impairment. The general allowance is for 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, 2014	December 31, 2013
--	-----------------------	----------------------

	(Dollars in thousands)	
Individually evaluated for impairment	\$37,954	\$47,018
Collectively evaluated for impairment	2,464,749	2,560,680
Total loans evaluated for impairment	\$2,502,703	\$2,607,698

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 the lower of the mortgage loan's carrying value or the property's 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. Charge-offs also include situations where we have received a payment from the borrower in an amount greater than the carrying value of the loan (principal outstanding less specific allowance). 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.

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During the three months ended September 30, 2014, one mortgage loan was satisfied by taking ownership of the real estate serving as collateral and during the nine months ended September 30, 2014, six mortgage loans were satisfied by taking ownership of the real estate serving as collateral compared to three and four mortgage loans for the same periods in 2013. 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		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Real estate owned at beginning of period	\$24,606	\$26,609	\$22,844	\$33,172
Real estate acquired in satisfaction of mortgage loans	1,748	5,441	11,755	6,285
Additions	—	52	—	532
Sales	(2,431	) (5,832	) (9,579	) (13,245
Impairments	(1,436	) (678	) (2,235	) (823
Depreciation	(153	) (159	) (451	) (488
Real estate owned at end of period	\$22,334	\$25,433	\$22,334	\$25,433

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, 2014	December 31, 2013
	(Dollars in thousands)	
Credit Exposure--By Payment Activity		
Performing	\$2,490,059	\$2,593,276
In workout	—	6,248
Delinquent	6,032	—
Collateral dependent	6,612	8,174
	\$2,502,703	\$2,607,698

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, the original interest rate and maturity date have not been modified, and we have not forgiven any principal amounts.

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, 2014 and December 31, 2013 totaled \$12.6 million and \$8.2 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.

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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, 2014	\$2,484	\$6,032	\$—	\$8,516	\$2,487,575	\$6,612	\$2,502,703
December 31, 2013	\$—	\$—	\$—	\$—	\$2,599,524	\$8,174	\$2,607,698

Financing receivables summarized in the following two tables 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
(Dollars in thousands)			
September 30, 2014			
Mortgage loans with an allowance	\$20,590	\$37,954	\$(17,364)
Mortgage loans with no related allowance	2,657	2,657	—
	\$23,247	\$40,611	\$(17,364)
December 31, 2013			
Mortgage loans with an allowance	\$30,171	\$47,018	\$(16,847)
Mortgage loans with no related allowance	3,264	3,264	—
	\$33,435	\$50,282	\$(16,847)
		Average Recorded Investment	Interest Income Recognized
(Dollars in thousands)			
Three months ended September 30, 2014			
Mortgage loans with an allowance		\$22,157	\$539
Mortgage loans with no related allowance		2,656	—
		\$24,813	\$539
Three months ended September 30, 2013			
Mortgage loans with an allowance		\$31,488	\$1,135
Mortgage loans with no related allowance		18,781	366
		\$50,269	\$1,501
Nine months ended September 30, 2014			
Mortgage loans with an allowance		\$23,580	\$1,696
Mortgage loans with no related allowance		2,656	—
		\$26,236	\$1,696
Nine months ended September 30, 2013			
Mortgage loans with an allowance		\$32,315	\$2,069
Mortgage loans with no related allowance		18,822	797
		\$51,137	\$2,866

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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, 2014 and December 31, 2013 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, 2014				
South Atlantic	6	\$11,747	\$(3,319)	) \$8,428
East North Central	1	2,196	(467)	) 1,729
West North Central	1	1,894	(857)	) 1,037
	8	\$15,837	\$(4,643)	) \$11,194
December 31, 2013				
East	1	\$3,712	\$(949)	) \$2,763
Mountain	7	22,140	(329)	) 21,811
South Atlantic	7	13,930	(4,177)	) 9,753
East North Central	1	2,219	(467)	) 1,752
West North Central	1	1,938	(475)) 1,463
West South Central	1	1,714	(256)) 1,458
	18	\$45,653	\$(6,653)) \$39,000

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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 and derivative instruments embedded in a convertible debt issue, presented in the consolidated balance sheets are as follows:

	September 30, 2014	December 31, 2013
	(Dollars in thousands)	
Assets		
Derivative instruments		
Call options	\$744,033	\$856,050
Other assets		
2015 notes hedges	39,061	107,041
Interest rate caps	3,644	6,103
Interest rate swap	—	712
	\$786,738	\$969,906
Liabilities		
Policy benefit reserves - annuity products		
Fixed index annuities - embedded derivatives	\$5,261,554	\$4,406,163
Other liabilities		
2015 notes embedded conversion derivative	39,061	107,041
Interest rate swap	1,252	—
	\$5,301,867	\$4,513,204

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

	Three Months Ended September 30, 2014		September 30, 2013	
	(Dollars in thousands)			
Change in fair value of derivatives:				
Call options	\$45,931	\$129,428	\$391,173	\$532,282
2015 notes hedges	(6,823	) 73,504	(27,124	) 101,799
2015 warrants	—	(9,199	) —	(9,199
Interest rate swap	254	(496	) (2,996	) 4,039
Interest rate caps	(144	) (209	) (2,459	) 2,109
	\$39,218	\$193,028	\$358,594	\$631,030
Change in fair value of embedded derivatives:				
2015 notes embedded conversion derivative	\$(6,823	) \$75,750	\$(31,356	) \$104,045
Fixed index annuities—embedded derivatives	(188,383	) (39,526	) 9,704	(112,958
	\$(195,206	) \$36,224	\$(21,652	) \$(8,913

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.

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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, 2014		December 31, 2013	
			Notional Amount (Dollars in thousands)	Fair Value	Notional Amount	Fair Value
Bank of America	A	A2	\$2,246,624	\$72,983	\$1,683,911	\$73,836
Barclays	A	A2	3,623,829	103,851	2,396,839	113,513
BNP Paribas	A+	A1	1,396,822	47,466	1,382,661	38,849
Citibank, N.A.	A	A2	3,140,186	104,580	1,536,547	72,310
Credit Suisse	A	A1	2,331,074	76,262	4,060,352	193,304
Deutsche Bank	A	A3	1,896,694	48,434	747,587	41,074
HSBC	AA-	A1	119,798	6,223	200,011	10,518
J.P. Morgan	A+	Aa3	447,612	15,838	786,429	36,863
Morgan Stanley	A-	Baa2	2,876,299	121,615	3,546,487	150,437
Royal Bank of Canada	AA-	Aa3	1,383,324	42,089	714,941	25,140
Wells Fargo	AA-	Aa3	3,282,302	104,692	2,221,874	100,206
			\$22,744,564	\$744,033	\$19,277,639	\$856,050

As of September 30, 2014 and December 31, 2013, we held \$715.3 million and \$818.2 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 \$64.1 million and \$71.7 million at September 30, 2014 and December 31, 2013, 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. During the nine months ended September 30, 2014, we revised future period assumptions for lapse rates and the expected costs of annual call options used in determining fixed index annuity embedded derivatives. These revisions decreased the change in fair value of embedded derivatives for the nine months ended September 30, 2014 by \$62.6 million, which after related adjustments to deferred sales inducements and deferred policy acquisition costs and income taxes, increased net income and earnings per common share - assuming dilution by \$14.8 million and \$0.19, respectively.

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, 2013 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, 2014	December 31, 2013
Maturity Date	Amount	Receive Rate	Rate	Counterparty	Fair Value	Fair Value
March 15, 2021	\$85,500	LIBOR	2.415 %	SunTrust	(Dollars in thousands) \$(1,252) \$712

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Details regarding the interest rate caps are as follows:

Maturity Date	Notional	Floating Rate	Cap	Counterparty	September 30, 2014	December 31, 2013
	Amount		Rate		Fair Value	Fair Value
					(Dollars in thousands)	
July 7, 2021	\$40,000	LIBOR	2.50 %	SunTrust	\$1,835	\$3,073
July 8, 2021	12,000	LIBOR	2.50 %	SunTrust	551	923
July 29, 2021	27,000	LIBOR	2.50 %	SunTrust	1,258	2,107
	\$79,000				\$3,644	\$6,103

The interest rate swap converts floating rates to fixed rates for seven years beginning March 2014. The interest rate caps cap our interest rates for seven years beginning July 2014. As of September 30, 2014, we held \$2.3 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 September 15, 2015 (the "2015 notes"), we entered into hedge transactions (the "2015 notes hedges") with two counterparties whereby we will 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. The 2015 notes hedges 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 hedges and 2015 notes embedded conversion derivative are adjusted to fair value each reporting period and unrealized gains and losses are reflected in our unaudited 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. We received \$15.6 million in cash proceeds from the sale of the 2015 warrants, which was recorded as an increase in additional paid-in capital. The number of shares and strike price of the warrants are subject to adjustment based on dividends we pay subsequent to selling the warrants. 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 11.7 million shares. 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.

During the nine months ended September 30, 2014, we entered into four separate partial unwind agreements with the two counterparties to the 2015 notes hedges and the 2015 warrants to coincide with the extinguishment of a portion of our 2015 notes (see [Note 6](#)) whereby we agreed to settle the related 2015 notes hedges and the 2015 warrants and received net cash from the counterparties totaling \$10.4 million. Subsequent to September 30, 2014 we entered into partial unwind agreements with the counterparties to the 2015 notes hedges and the 2015 warrants and will receive net cash totaling \$6.2 million. Subsequent to the settlement of these unwind agreements and certain conversion rate adjustments due to dividends paid, 2015 notes hedges remain outstanding whereby we will receive the cash equivalent of the conversion spread on 1.8 million shares of our common stock based upon a strike price of \$12.35 per share and warrants remain outstanding for the purchase of up to 1.8 million shares of our common stock at a strike price of \$15.75 per share. At September 30, 2014 and 2013, the remaining 2015 warrants were dilutive as the average price of our common stock exceeded the \$15.75 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, 2014 and 2013.

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.

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6. Notes Payable

The 5.25% Contingent Convertible Senior Notes due December 15, 2029 (the "2029 notes") are accounted for separately as a liability component and an equity component in the consolidated balance sheets. The carrying amount of the 2015 notes and the 2029 notes, the carrying amount of the equity component of the 2029 notes and the amount by which the if-converted value exceeds the outstanding principal for both the 2015 notes and the 2029 notes are as follows:

	September 30, 2014		December 31, 2013	
	September 2015	December 2029	September 2015	December 2029
	Notes	Notes	Notes	Notes
	(Dollars in thousands)			
Notes payable:				
Principal amount of liability component	\$45,450	\$32,142	\$91,951	\$68,373
Unamortized discount	(1,898)	(399)	(6,623)	(3,743)
Net carrying amount of liability component	\$43,552	\$31,743	\$85,328	\$64,630
Additional paid-in capital:				
Carrying amount of equity component		\$4,325		\$15,586
Amount by which the if-converted value exceeds principal	\$38,728	\$46,282	\$104,403	\$113,169

The discount is being amortized over the expected lives of the notes, which is the maturity date of September 15, 2015 for the 2015 notes and the first put/call date of December 15, 2014 for the 2029 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 \$1.9 million and \$7.6 million for the three and nine months ended September 30, 2014 compared to \$7.1 million and \$21.1 million for the same periods in 2013.

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, 2014 and 2013, 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, 2014 and 2013. 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.

During the nine months ended September 30, 2014, we extinguished \$36.2 million principal amount of our 2029 notes and \$46.5 million principal amount of our 2015 notes. Total consideration paid to holders of the 2029 notes consisted of \$66.8 million in cash and \$23.2 million in shares of our common stock (946,793 shares). The carrying value of the 2029 notes at extinguishment was \$34.6 million which resulted in a loss of \$2.5 million on extinguishment of debt, net of income taxes. Total consideration paid to holders of the 2015 notes consisted of \$52.9 million in cash and \$33.1 million in shares of our common stock (1,496,664 shares). The carrying value of the 2015 notes at extinguishment was \$43.8 million which resulted in a loss of \$5.4 million, net of income taxes.

Subsequent to September 30, 2014, we extinguished \$23.1 million principal amount of our 2015 notes. Total consideration paid to holders of the 2015 notes consisted of \$30.0 million in cash and \$15.1 million in shares of our common stock (618,391 shares). The carrying value of the 2015 notes at extinguishment was \$22.2 million which resulted in a loss of \$1.1 million, net of income taxes.

Under our \$140 million four year unsecured revolving line of credit agreement, we are required to maintain a minimum risk-based capital ratio at our subsidiary, American Equity Investment Life Insurance Company ("American Equity Life"), of at least 275%, a maximum ratio of adjusted debt to total adjusted capital of 0.35, and a minimum level of statutory surplus at American Equity Life equal to the sum of 1) 80% of statutory surplus at September 30, 2013, 2) 50% of the statutory net income for each fiscal quarter ending after September 30, 2013, and 3) 50% of all capital contributed to American Equity Life after September 30, 2013. The agreement contains an accordion feature that allows us, on up to three occasions and subject to credit availability, to increase the credit facility by an additional

\$50 million in the aggregate. We also have the ability to extend the maturity date by an additional one year past the initial maturity date of November 22, 2017 with the consent of the extending banks. There are currently no guarantors of the credit facility, but certain of our subsidiaries must guarantee our obligations under the credit agreement if such subsidiaries guarantee other material amounts of our debt. No amounts were outstanding at September 30, 2014 and December 31, 2013.

As part of our investment strategy, we enter into securities repurchase agreements (short-term collateralized borrowings). The maximum amount borrowed was \$138.7 million and \$258.6 million during the nine months ended September 30, 2014 and 2013, respectively. 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 \$0.9 million and \$9.4 million for the three and nine months ended September 30, 2014 compared to \$131.5 million and \$47.5 million for the three and nine months ended September 30, 2013. The weighted average interest rate on amounts due under repurchase agreements was 0.35% and 0.15% for the three and nine months ended September 30, 2014 compared to 0.17% and 0.18% for the three and nine months ended September 30, 2013.

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7. Commitments and Contingencies

We are occasionally involved in litigation, both as a defendant and as a plaintiff. In addition, state regulatory bodies, such as state insurance departments, the SEC, FINRA, the Department of Labor, and other regulatory bodies regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, the Employee Retirement Income Security Act of 1974, as amended, and laws governing the activities of broker-dealers.

In accordance with applicable accounting guidelines, we establish an accrued liability for litigation and regulatory matters when those matters present loss contingencies that are both probable and estimable. As a litigation or regulatory matter is developing we, in conjunction with outside counsel, evaluate on an ongoing basis whether the matter presents a loss contingency that meets conditions indicating the need for accrual and/or disclosure, and if not the matter will continue to be monitored for further developments. If and when the loss contingency related to litigation or regulatory matters is deemed to be both probable and estimable, we will establish an accrued liability with respect to that matter and will continue to monitor the matter for further developments that may affect the amount of the accrued liability.

In recent years, companies in the life insurance and annuity business have faced litigation, including class action lawsuits, alleging improper product design, improper sales practices and similar claims. We were a defendant in a purported class action, McCormack, et al. v. American Equity Investment Life Insurance Company, et al., in the United States District Court for the Central District of California, Western Division and Anagnostis v. American Equity, et al., coordinated in the Central District, entitled, In Re: American Equity Annuity Practices and Sales Litigation (complaint filed September 7, 2005) (the "Los Angeles Case"), involving allegations of improper sales practices and similar claims as described below.

The Los Angeles Case was a consolidated action involving several lawsuits filed by putative class members seeking class action status for a national class of purchasers of annuities issued by us. The allegations generally attacked the suitability of sales of deferred annuity products to persons over the age of 65. The plaintiffs sought rescission and injunctive relief including restitution and disgorgement of profits on behalf of all class members under California Business & Professions Code section 17200 et seq. and Racketeer Influenced and Corrupt Organizations Act; compensatory damages for breach of fiduciary duty and aiding and abetting of breach of fiduciary duty; unjust enrichment and constructive trust; and other pecuniary damages under California Civil Code section 1750 and California Welfare & Institutions Codes section 15600 et seq. On July 30, 2013, the parties entered into a settlement agreement and stipulated to certification of the case as a class action for settlement purposes only. Notice of the terms of the settlement was mailed to the members of the class on October 7, 2013 and settlement claim forms were due from members of the class on or before December 6, 2013. On January 27, 2014, a hearing was held regarding the fairness of the settlement. On January 29, 2014, the District Court signed a final order approving the settlement and finding the settlement is fair and represents a complete resolution of all claims asserted on behalf of the class. On January 30, 2014, a final judgment was entered dismissing the case on the merits and with prejudice. On February 28, 2014, a member of the class filed an appeal of the District Court's approval of the terms of the settlement agreement with the United States Court of Appeals for the Ninth Circuit.

We recorded an estimated litigation liability of \$17.5 million during the third quarter of 2012 related to the Los Angeles Case. We increased our estimated litigation liability for this matter to \$21.2 million during the fourth quarter of 2013 following the passage of the deadline for submission of claims by class members in the lawsuit and based upon information available at that time. However, we decreased the liability by \$2.3 million in the first quarter of 2014 as additional information became available concerning the nature and magnitude of the claims received. In addition, during the first quarter of 2014, we paid \$7.8 million in legal fees to the plaintiffs' counsel. The estimated litigation liability at September 30, 2014 is \$11.1 million. While review of the claim forms has been stayed due to the appeal and it is difficult to predict the amount of the liabilities that will ultimately result from the completion of the claims process, the \$11.1 million litigation liability represents our best estimate of probable loss with respect to this litigation. In light of the inherent uncertainties involved in the matter described above, there can be no assurance that such litigation, or any other pending or future litigation, will not have a material adverse effect on our business, financial condition, or results of operations.

In addition to our commitments to fund mortgage loans, we have unfunded commitments at September 30, 2014 to limited partnerships of \$18.6 million and to secured bank loans of \$9.1 million.

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8. Earnings Per Share

The following table sets forth the computation of earnings per common share and earnings per common share - assuming dilution:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2014	2013
(Dollars in thousands, except per share data)				
Numerator:				
Net income - numerator for earnings per common share	\$67,815	\$56,181	\$94,806	\$202,325
Denominator:				
Weighted average common shares outstanding (1)	75,082,852	65,129,442	74,030,290	64,239,117
Effect of dilutive securities:				
Convertible senior notes	1,982,089	6,601,347	2,485,974	6,601,347
2015 warrants	1,230,020	1,388,826	1,730,077	462,942
Stock options and deferred compensation agreements	1,115,927	1,440,101	1,185,973	1,155,670
Restricted stock units	56,222	—	44,944	—
Denominator for earnings per common share - assuming dilution	79,467,110	74,559,716	79,477,258	72,459,076
Earnings per common share	\$0.90	\$0.86	\$1.28	\$3.15
Earnings per common share - assuming dilution	\$0.85	\$0.75	\$1.19	\$2.79

(1) Weighted average common shares outstanding include shares vested under the NMO Deferred Compensation Plan and exclude unallocated shares held by the ESOP.

Options to purchase shares of our common stock that were outstanding during the respective periods indicated but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares are as follows:

Period	Number of Shares	Range of Exercise Prices	
		Minimum	Maximum
Three months ended September 30, 2014	1,275,050	\$24.79	\$24.79
Three months ended September 30, 2013	—	\$—	\$—
Nine months ended September 30, 2014	1,275,050	\$24.79	\$24.79
Nine months ended September 30, 2013	—	\$—	\$—

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's discussion and analysis reviews our unaudited consolidated financial position at September 30, 2014, and the unaudited consolidated results of operations for the three and nine month periods ended September 30, 2014 and 2013, and where appropriate, factors that may affect future financial performance. This analysis should be read in conjunction with our unaudited consolidated financial statements and notes thereto appearing elsewhere in this Form 10-Q, and the audited consolidated financial statements, notes thereto and selected consolidated financial data appearing in our Annual Report on Form 10-K for the year ended December 31, 2013.

Cautionary Statement Regarding Forward-Looking Information

All statements, trend analyses and other information contained in this report and elsewhere (such as in filings by us with the Securities and Exchange Commission ("SEC"), press releases, presentations by us or our management or oral statements) relative to markets for our products and trends in our operations or financial results, as well as other statements including words such as "anticipate", "believe", "plan", "estimate", "expect", "intend", and other similar expressions, constitute forward-looking statements. We caution that these statements may and often do vary from actual results and the differences between these statements and actual results can be material. Accordingly, we cannot assure you that actual results will not differ materially from those expressed or implied by the forward-looking statements. Factors that could contribute to these differences include, among other things:

general economic conditions and other factors, including prevailing interest rate levels and stock and credit market performance which may affect (among other things) our ability to sell our products, our ability to access capital resources and the costs associated therewith, the fair value of our investments, which could result in impairments and other than temporary impairments, and certain liabilities, and the lapse rate and profitability of policies;

customer response to new products and marketing initiatives;

changes in Federal income tax laws and regulations which may affect the relative income tax advantages of our products;

increasing competition in the sale of annuities;

regulatory changes or actions, including those relating to regulation of financial services affecting (among other things) bank sales and underwriting of insurance products and regulation of the sale, underwriting and pricing of products; and

the risk factors or uncertainties listed from time to time in our filings with the SEC.

For a detailed discussion of these and other factors that might affect our performance, see Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013.

Overview

We specialize in the sale of individual annuities (primarily deferred annuities) and, to a lesser extent, we also sell life insurance policies. Under U.S. generally accepted accounting principles ("GAAP"), premium collections for deferred annuities are reported as deposit liabilities instead of as revenues. Similarly, cash payments to policyholders are reported as decreases in the liabilities for policyholder account balances and not as expenses. Sources of revenues for products accounted for as deposit liabilities are net investment income, surrender and other charges deducted from the account balances of policyholders, net realized gains (losses) on investments and changes in fair value of derivatives. Components of expenses for products accounted for as deposit liabilities are interest sensitive and index product benefits (primarily interest credited to account balances), changes in fair value of embedded derivatives, amortization of deferred sales inducements and deferred policy acquisition costs, other operating costs and expenses and income taxes.

Our business model contemplates continued growth in invested assets and operating income while maintaining a high quality investment portfolio that will not experience significant losses from impairments of invested assets. Growth in invested assets is predicated on a continuation of our high sales while at the same time maintaining a high level of retention of the funds received. The economic and personal investing environments continue to be conducive for high sales levels as retirees and others look to put their money in instruments that will protect their principal and provide them with consistent cash flow sources in their retirement years. We are committed to maintaining a high quality investment portfolio with limited exposure to below investment grade securities and other riskier assets.

Earnings from products accounted for as deposit liabilities are primarily generated from the excess of net investment income earned over the interest credited or the cost of providing index credits to the policyholder, or the "investment spread." Our investment spread is summarized as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Average yield on invested assets	4.89%	5.02%	4.89%	4.99%
Aggregate cost of money	2.07%	2.22%	2.12%	2.26%
Aggregate investment spread	2.82%	2.80%	2.77%	2.73%
Impact of:				
Investment yield - additional prepayment income	0.07%	0.05%	0.05%	0.06%
Cost of money benefit of over hedging	0.05%	0.03%	0.03%	0.04%

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Our investment spread has been impacted by shortfalls in investment income from excess liquidity resulting from a lag in the reinvestment of proceeds of government agency bonds called for redemption. See Results of Operations - Net investment income for additional information regarding our excess liquidity.

The cost of money for fixed index annuities and average crediting rates for fixed rate annuities are computed based upon policyholder account balances and do not include the impact of amortization of deferred sales inducements. See Critical Accounting Policies - Deferred Policy Acquisition Costs and Deferred Sales Inducements included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2013. With respect to our fixed index annuities, the cost of money includes the average crediting rate on amounts allocated to the fixed rate strategy, costs we incur to fund the annual index credits (primarily costs to purchase call options) and where applicable, minimum guaranteed interest credited. Proceeds received upon expiration or early termination of call options purchased to fund annual index credits are recorded as part of the change in fair value of derivatives, and are largely offset by an expense for interest credited to annuity policyholder account balances. See Critical Accounting Policies - Policy Liabilities for Fixed Index Annuities and Financial Condition - Derivative Instruments included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2013. As reported in previous filings, in response to the persistent low interest rate environment, we have been reducing policyholder crediting rates for new annuities and existing annuities since the fourth quarter of 2011. Spread results for the 2014 and 2013 periods reflect the benefit from these reductions; however, the reductions in cost of money were offset by continued lower yields available on investments including those purchased with the reinvestment of proceeds from calls of callable bonds in our investment portfolio. In 2014, we have initiated additional renewal crediting rate reductions for policies issued prior to July 20, 2010. These rate reductions will occur on policy anniversary dates over a fifteen month period that began on April 14, 2014, with the majority of the rate reductions completed by May 15, 2015. When fully implemented, we estimate that the cost of money for approximately \$15 billion of policyholder funds will be reduced by 0.20%.

The current interest rate environment with low yields for investments with the credit quality we prefer presents a strong headwind to restoring our investment spread to the 3.00% target rate. With our portfolio yield still under pressure from lower rates on benchmark U.S. Treasury securities and narrower credit spreads, further adjustments to new and renewal crediting rates will be considered. We have on average 0.60% of room to reduce rates before we would reach guaranteed rates on the entire September 30, 2014 in force book of business. We implemented modest reductions in certain new money rates in early October 2014, which we believe will not have an impact on our sales momentum. This represents the first adjustments to new money rates since the third quarter of 2013 when we increased rates in response to rising investment yields at that time. While we continue to be reluctant to reduce new money rates for competitive reasons, we remain aware of our spread and return on average equity objectives. We will continue to monitor the competitive environment and make further adjustments to new money rates based upon changes in market conditions.

Our profitability depends in large part upon the amount of assets under our management, investment spreads we earn on our policyholder account balances, our ability to manage our investment portfolio to maximize returns and minimize risks such as interest rate changes and defaults or impairment of investments, our ability to manage interest rates credited to policyholders and costs of the options purchased to fund the annual index credits on our fixed index annuities, our ability to manage the costs of acquiring new business (principally commissions to agents and bonuses credited to policyholders) and our ability to manage our operating expenses.

Results of Operations for the Three and Nine Months Ended September 30, 2014 and 2013

Annuity deposits by product type collected during the three and nine months ended September 30, 2014 and 2013, were as follows:

Product Type	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Fixed index annuities:				
Index strategies	\$838,773	\$722,088	\$2,262,277	\$2,091,166

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Fixed strategy	202,676	254,399	620,829	782,944
	1,041,449	976,487	2,883,106	2,874,110
Fixed rate annuities:				
Single-year rate guaranteed	10,959	16,238	43,359	56,552
Multi-year rate guaranteed	13,741	47,281	90,391	142,828
Single premium immediate annuities	5,633	13,618	18,059	45,422
	30,333	77,137	151,809	244,802
Total before coinsurance ceded	1,071,782	1,053,624	3,034,915	3,118,912
Coinsurance ceded	36,308	42,004	118,699	129,183
Net after coinsurance ceded	\$1,035,474	\$1,011,620	\$2,916,216	\$2,989,729

Annuity deposits before coinsurance ceded increased 2% during the third quarter of 2014 and decreased 3% during the nine months ended September 30, 2014 compared to the same periods in 2013. We attribute the decrease in year to date annuity deposits to certain competitive factors in the market. In August 2014, we launched three initiatives intended to enhance our competitive position: a new index crediting strategy, revisions to the payouts under our lifetime income benefit rider and a new option for payment of commissions to independent agents. These initiatives contributed to the increase in third quarter annuity deposits.

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Net income, in general, has been positively impacted by the growth in the volume of business in force and the investment spread earned on this business. The average amount of annuity liabilities outstanding (net of annuity liabilities ceded under coinsurance agreements) increased 13% to \$33.8 billion for the third quarter of 2014 and increased 13% to \$32.9 billion for the nine months ended September 30, 2014 compared to \$30.0 billion and \$29.0 billion for the same periods in 2013. Our investment spread measured in dollars was \$206.8 million for the third quarter of 2014 and \$587.9 million for the nine months ended September 30, 2014 compared to \$182.5 million and \$511.5 million for the same periods in 2013. As previously mentioned, our investment spread has been negatively impacted by the extended low interest rate environment (see Net investment income).

Net income is also impacted by the change in fair value of derivatives and embedded derivatives which fluctuates from period to period based upon changes in fair values of call options purchased to fund the annual index credits for fixed index annuities and changes in interest rates used to discount the embedded derivative liability. Net income for the three months ended September 30, 2014 was positively impacted by increases in the discount rates used to estimate our embedded derivative liabilities, while net income for the nine months ended September 30, 2014 was negatively impacted by decreases in the discount rates used to estimate our embedded derivative liabilities. Net income for the three and nine months ended September 30, 2013 was positively impacted by increases in the discount rates used to estimate our embedded derivative liabilities. Net income for the nine months ended September 30, 2014 was also impacted by revisions of assumptions used in determining fixed index annuity embedded derivatives that were made in the second quarter of 2014. These revisions, which consisted of changes in the lapse and expected costs of annual call options assumptions, decreased the change in fair value of embedded derivatives for the nine months ended September 30, 2014 by \$62.6 million, which after related adjustments to deferred sales inducements and deferred policy acquisition costs and income taxes, increased net income for the nine months ended September 30, 2014 by \$14.8 million. See Change in fair value of embedded derivatives.

We periodically revise the key assumptions used in the calculation of amortization of deferred policy acquisition costs and deferred sales inducements retrospectively through an unlocking process when estimates of current or future gross profits/margins (including the impact of realized investment gains and losses) to be realized from a group of products are revised. The impact of unlocking during the three and nine months ended September 30, 2014 was a \$12.6 million decrease in amortization of deferred sales inducements and a \$35.5 million decrease in amortization of deferred policy acquisition costs and included the impact of account balance true ups as of September 30, 2014 and adjustment to future period assumptions for investment spread, surrenders and certain expenses. The unlocking process increased net income for the three and nine months ended September 30, 2014 by \$31.0 million. The impact of unlocking during the three and nine months ended September 30, 2013 was a \$11.1 million decrease in amortization of deferred sales inducements and a \$18.5 million decrease in amortization of deferred policy acquisition costs, which increased net income for the three and nine months ended September 30, 2013 by \$19.1 million.

Net income for the 2014 periods was negatively impacted by a revision of assumptions used in determining reserves held for living income benefit riders. This revision was consistent with unlocking for deferred policy acquisition costs and deferred sales inducements. The impact increased interest sensitive and index product benefits for the three and nine months ended September 30, 2014 by \$12.4 million and decreased net income for the three and nine months ended September 30, 2014 by \$8.0 million. For the three and nine months ended September 30, 2013, the impact from the revision of these assumptions decreased interest sensitive and index product benefits by \$1.8 million and increased net income for the three and nine months ended September 30, 2013 by \$1.1 million.

Net income for the 2013 periods was negatively impacted due to the partial unwind agreements we entered into related to the 2015 notes hedges and 2015 warrants. The impact decreased the change in fair value of derivatives for the three and nine months ended September 30, 2013 by \$11.4 million and decreased net income for the three and nine months ended September 30, 2013 by \$6.7 million.

Operating income (a non-GAAP financial measure) increased 7% to \$64.0 million in the third quarter of 2014 and increased 13% to \$139.9 million for the nine months ended September 30, 2014 compared to \$59.8 million and \$123.6 million for the same periods in 2013.

In addition to net income, we have consistently utilized operating income, a non-GAAP financial measure commonly used in the life insurance industry, as an economic measure to evaluate our financial performance. Operating income

equals net income adjusted to eliminate the impact of net realized gains (losses) on investments including net OTTI losses recognized in operations, fair value changes in derivatives and embedded derivatives, losses on extinguishment of debt and changes in litigation reserves. Because these items fluctuate from year to year in a manner unrelated to core operations, we believe measures excluding their impact are useful in analyzing operating trends. We believe the combined presentation and evaluation of operating income together with net income provides information that may enhance an investor's understanding of our underlying results and profitability.

Operating income is not a substitute for net income determined in accordance with GAAP. The adjustments made to derive operating income are important to understanding our overall results from operations and, if evaluated without proper context, operating income possesses material limitations. As an example, we could produce a low level of net income in a given period, despite strong operating performance, if in that period we experience significant net realized losses from our investment portfolio. We could also produce a high level of net income in a given period, despite poor operating performance, if in that period we generate significant net realized gains from our investment portfolio. As an example of another limitation of operating income, it does not include the decrease in cash flows expected to be collected as a result of credit loss OTTI. Therefore, our management reviews net realized investment gains (losses) and analyses of our net investment income, including impacts related to OTTI write-downs, in connection with their review of our investment portfolio. In addition, our management examines net income as part of their review of our overall financial results.

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The adjustments made to net income to arrive at operating income for the three and nine months ended September 30, 2014 and 2013 are set forth in the table that follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Reconciliation of net income to operating income:				
Net income	\$67,815	\$56,181	\$94,806	\$202,325
Net realized (gains) losses and net OTTI losses on investments, net of offsets	1,551	890	3,476	(5,488)
Change in fair value of derivatives and embedded derivatives - index annuities, net of offsets	(4,957)	(4,907)	34,636	(75,285)
Change in fair value of derivatives and embedded derivatives - debt, net of income taxes	(427)	7,136	29	3,098
Extinguishment of debt, net of income taxes	—	548	7,912	893
Litigation reserve, net of offsets	—	—	(916)	(1,969)
Operating income	\$63,982	\$59,848	\$139,943	\$123,574

The amounts disclosed in the reconciliation above are net of related adjustments to amortization of deferred sales inducements and deferred policy acquisition costs and income taxes.

Operating income for the 2014 periods includes benefit from unlocking which decreased amortization of deferred sales inducements by \$10.7 million and amortization of deferred acquisition costs by \$33.0 million and increased operating income by \$28.2 million for the three and nine months ended September 30, 2014. The three and nine months ended September 30, 2013 includes benefit from unlocking which decreased amortization of deferred sales inducements by \$12.6 million and amortization of deferred acquisition costs by \$20.4 million and increased operating income by \$21.3 million.

Operating income for the 2014 periods also includes expense from a revision of assumptions used in determining reserves held for living income benefit riders which increased interest sensitive and index product benefits for the three and nine months ended September 30, 2014 by \$12.4 million and decreased operating income for the three and nine months ended September 30, 2014 by \$8.0 million. For the three and nine months ended September 30, 2013, the impact decreased interest sensitive and index product benefits by \$1.8 million and increased operating income by \$1.1 million.

Fair value accounting for the 2015 notes hedges and 2015 warrants fluctuates from year to year based upon changes in the fair value of our common stock, its dividend yield and its volatility. The net effect of derivatives and embedded derivatives, net of offsets adjustment to arrive at operating income for the three and nine months ended September 30, 2013 in the above reconciliation includes a positive \$6.7 million related to the change in fair value of the 2015 notes hedges and 2015 warrants.

Premiums and other considerations decreased 39% to \$6.0 million in the third quarter of 2014 and decreased 35% to \$22.5 million for the nine months ended September 30, 2014 compared to \$9.9 million and \$34.5 million for the same periods in 2013. These revenues are comprised of life insurance premiums and premiums from life contingent single premium immediate annuities including life contingent supplemental contracts issued upon annuitization of deferred annuities. Life insurance premiums have remained consistent while premiums from life contingent single premium immediate annuities (\$3.4 million and \$7.4 million for the third quarter of 2014 and 2013, respectively, and \$14.2 million and \$26.4 million for the nine months ended September 30, 2014 and 2013, respectively) have decreased because we have adjusted the rates offered on these products to be less competitive in the low interest rate environment.

Annuity product charges (surrender charges assessed against policy withdrawals and fees deducted from policyholder account balances for lifetime income benefit riders) increased 21% to \$32.0 million in the third quarter of 2014 and increased 21% to \$86.5 million for the nine months ended September 30, 2014 compared to \$26.5 million and \$71.4 million for the same periods in 2013. The components of annuity product charges are set forth in the table that

follows:

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	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2014	2013	2014	2013	
	(Dollars in thousands)				
Surrender charges	\$11,717	\$11,160	\$37,082	\$33,954	
Lifetime income benefit riders (LIBR) fees	20,241	15,291	49,395	37,489	
	\$31,958	\$26,451	\$86,477	\$71,443	
Withdrawals from annuity policies subject to surrender charges	\$66,476	\$79,693	\$252,993	\$239,003	
Average surrender charge collected on withdrawals subject to surrender charges	17.6	% 14.0	% 14.7	% 14.2	%

Fund values on policies subject to LIBR fees	\$3,301,219	\$2,681,460	\$8,733,843	\$6,996,570	
Weighted average per policy LIBR fee	0.61	% 0.57	% 0.57	% 0.54	%

The increases in fees assessed for lifetime income benefit riders were primarily due to a larger volume of business in force subject to the fee. See Interest sensitive and index product benefits below for corresponding expense recognized on lifetime income benefit riders.

Net investment income increased 9% to \$386.9 million in the third quarter of 2014 and increased 11% to \$1.1 billion for the nine months ended September 30, 2014 compared to \$354.1 million and \$1.0 billion for the same periods in 2013. These increases were principally attributable to the growth in our annuity business and a corresponding increase in our invested assets. Average invested assets excluding derivative instruments (on an amortized cost basis) increased 12% to \$31.7 billion for the third quarter of 2014 and increased 13% to \$30.8 billion for the nine months ended September 30, 2014 compared to \$28.4 billion and \$27.3 billion for the same periods in 2013. The average yield earned on average invested assets was 4.89% for the three and nine months ended September 30, 2014 compared to 5.02% and 4.99% for the same periods in 2013.

The decrease in yield earned on average invested assets was attributable to yields on investments purchased in 2014 and 2013 being lower than the overall portfolio yield. In addition, net investment income and average yield in the second and third quarters of 2014 and the first two quarters of 2013 were negatively impacted by a lag in reinvestment of proceeds from bonds called for redemption during the period and earlier periods into new assets causing excess liquidity held in low yielding cash and other short-term investments. The average balance held in cash and short-term investments was \$0.7 billion and \$0.4 billion for the three and nine months ended September 30, 2014 and \$0.3 billion and \$1.3 billion for the three and nine months ended September 30, 2013. The average yield on our cash and short-term investments for the three and nine months ended September 30, 2014 was 0.07% and for the three and nine months ended September 30, 2013 was 0.64% and 0.48%, respectively. Additionally, net investment income and average yield was positively impacted by prepayment and fee income received resulting in additional net investment income of \$5.4 million and \$10.5 million for the three and nine months ended September 30, 2014 and \$3.8 million and \$11.8 million for the same periods in 2013, respectively.

Change in fair value of derivatives consists primarily of call options purchased to fund annual index credits on fixed index annuities, the 2015 notes hedges related to our 2015 notes and an interest rate swap and interest rate caps that hedge our floating rate subordinated debentures. The components of change in fair value of derivatives are as follows:

	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2014	2013	2014	2013	
	(Dollars in thousands)				
Call options:					
Gain on option expiration	\$223,504	\$144,830	\$550,935	\$354,530	
Change in unrealized gains/losses	(177,573) (15,402) (159,762) 177,752	

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2015 notes hedges	(6,823) 73,504	(27,124) 101,799
2015 warrants	—	(9,199) —	(9,199
Interest rate swap	254	(496) (2,996) 4,039
Interest rate caps	(144) (209) (2,459) 2,109
	\$39,218	\$193,028	\$358,594	\$631,030

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The differences between the change in fair value of derivatives between periods for call options are primarily due to the performance of the indices upon which our call options are based. A substantial portion of our call options are based upon the S&P 500 Index with the remainder based upon other equity and bond market indices. The range of index appreciation (after applicable caps, participation rates and asset fees) for options expiring during the three and nine months ended September 30, 2014 and 2013 is as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
S&P 500 Index				
Point-to-point strategy	1.0 - 11.5%	2.3 - 11.5%	1.0 - 11.5%	1.5 - 11.5%
Monthly average strategy	0.8 - 9.0%	0.0 - 18.2%	0.8 - 11.1%	0.0 - 19.0%
Monthly point-to-point strategy	0.0 - 17.9%	0.0 - 18.2%	0.0 - 19.9%	0.0 - 19.0%
Fixed income (bond index) strategies	0.0 - 8.0%	0.0 - 0.0%	0.0 - 8.0%	0.0 - 8.0%

The change in fair value of derivatives is also influenced by the aggregate costs of options purchased. The aggregate cost of options has increased primarily due to an increased amount of fixed index annuities in force. The aggregate cost of options is also influenced by the amount of policyholder funds allocated to the various indices and market volatility which affects option pricing. See Critical Accounting Policies - Policy Liabilities for Fixed Index Annuities included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2013.

The fair value of the 2015 warrants primarily changes based upon changes in the price of our common stock. The fair value of the 2015 notes hedges changes based upon changes in the price of our common stock, interest rates, stock price volatility, dividend yield and the time to expiration of the 2015 notes hedges. Similarly, the fair value of the conversion option obligation to the holders of the 2015 notes changes based upon these same factors and the conversion option obligation is accounted for as an embedded derivative liability with changes in fair value reported in the Change in fair value of embedded derivatives. The amount of the change in fair value of the 2015 notes hedges has historically been equal to the amount of the change in the related embedded derivative liability and there has been an offsetting expense in the change in fair value of embedded derivatives. Due to the partial unwind agreements we entered into in the second quarter of 2014, the decrease in the change in fair value of 2015 notes embedded conversion derivative liability exceeded the decrease in the change in fair value of the 2015 notes hedges by \$4.2 million for the nine months ended September 30, 2014. Due to the partial unwind agreements we entered into in the third quarter of 2013, the amount of the change in fair value of the 2015 notes hedges and the amount of the change in the related embedded derivative liability are not equal for the three and nine months ended September 30, 2013 by \$2.2 million. See Note 5 to our unaudited consolidated financial statements for a discussion of the unwind agreements, 2015 notes hedges and the 2015 warrants.

Net realized gains (losses) on investments, excluding OTTI losses include gains and losses on the sale of securities and impairment losses on mortgage loans