AMERICAN EQUITY INVESTMENT LIFE HOLDING CO
Form 10-Q
November 09, 2012

FORM 10-Q

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

(Mark One)

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

For the quarterly period ended September 30, 2012

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

For the transition period from ________ to ________
Commission File Number : 001-31911
American Equity Investment Life Holding Company
(Exact name of registrant as specified in its charter)

Iowa	42-1447959
(State of Incorporation)	(I.R.S. Employer Identification No.)
6000 Westown Parkway West Des Moines, Iowa	50266
(Address of principal executive offices)	(Zip Code)
Registrant's telephone number, including area code	(515) 221-0002
	(Telephone)

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $1	New York Stock Exchange

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

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

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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

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

APPLICABLE TO CORPORATE ISSUERS:
Shares of common stock outstanding at October 31, 2012: 62,805,580

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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 per share data)

	September 30, 2012 (Unaudited)	December 31, 2011
Assets		
Investments:		
Fixed maturity securities:		
Available for sale, at fair value (amortized cost: 2012 - $20,136,014; 2011 - $16,980,279)	$22,410,492	$18,464,109
Held for investment, at amortized cost (fair value: 2012 - $63,759; 2011 - $2,644,422)	76,048	2,644,206
Equity securities, available for sale, at fair value (cost: 2012 - $50,597; 2011 - $58,438)	61,604	62,845
Mortgage loans on real estate	2,724,321	2,823,047
Derivative instruments	577,784	273,314
Other investments	196,779	115,930
Total investments	26,047,028	24,383,451
Cash and cash equivalents	2,397,434	404,952
Coinsurance deposits	2,913,273	2,818,642
Accrued investment income	276,875	228,937
Deferred policy acquisition costs	1,639,791	1,683,857
Deferred sales inducements	1,234,471	1,242,787
Deferred income taxes	—	21,981
Income taxes recoverable	—	8,441
Other assets	88,901	81,671
Total assets	$34,597,773	$30,874,719
Liabilities and Stockholders' Equity		
Liabilities:		
Policy benefit reserves	$30,980,046	$28,118,716
Other policy funds and contract claims	457,162	400,594
Notes payable	306,696	297,608
Subordinated debentures	245,825	268,593
Deferred income taxes	73,835	—
Income taxes payable	1,415	—
Other liabilities	817,841	380,529
Total liabilities	32,882,820	29,466,040
Stockholders' equity:		
Preferred stock, par value $1 per share, 2,000,000 shares authorized, 2012 and 2011 no shares issued and outstanding	—	—
	61,548	57,837

Common stock, par value $1 per share, 200,000,000 shares authorized; issued and outstanding: 2012 - 61,548,127 shares (excluding 5,089,549 treasury shares); 2011 - 57,836,540 shares (excluding 5,616,595 treasury shares)		
Additional paid-in capital	493,797	468,281
Unallocated common stock held by ESOP; 2012 - 294,770 shares; 2011 - 336,093 shares	(2,931)	(3,620)
Accumulated other comprehensive income	712,186	457,229
Retained earnings	450,353	428,952
Total stockholders' equity	1,714,953	1,408,679
Total liabilities and stockholders' equity	$34,597,773	$30,874,719

See accompanying notes to unaudited consolidated financial statements.

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except per share data)
(Unaudited)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Revenues:				
Traditional life insurance premiums	$3,300	$3,126	$9,770	$9,331
Annuity product charges	23,875	20,405	65,176	57,259
Net investment income	318,594	305,502	965,763	894,508
Change in fair value of derivatives	161,090	(333,621)	269,404	(206,997)
Net realized losses on investments, excluding other than temporary impairment ("OTTI") losses	(1,238)	(17,292)	(7,925)	(19,339)
OTTI losses on investments:				
Total OTTI losses	—	(5,133)	(2,156)	(10,346)
Portion of OTTI losses recognized from other comprehensive income	(1,686)	(3,758)	(3,389)	(7,345)
Net OTTI losses recognized in operations	(1,686)	(8,891)	(5,545)	(17,691)
Total revenues	503,935	(30,771)	1,296,643	717,071
Benefits and expenses:				
Insurance policy benefits and change in future policy benefits	1,865	1,888	6,232	6,282
Interest sensitive and index product benefits	246,105	223,232	527,961	621,317
Amortization of deferred sales inducements	7,709	(28,065)	50,359	22,892
Change in fair value of embedded derivatives	188,201	(205,565)	466,278	(138,225)
Interest expense on notes payable	7,141	7,984	21,208	23,723
Interest expense on subordinated debentures	3,235	3,488	10,384	10,435
Interest expense on amounts due under repurchase agreements	—	—	—	5
Amortization of deferred policy acquisition costs	25,954	(28,930)	105,086	65,155
Other operating costs and expenses	36,170	15,903	76,785	50,011
Total benefits and expenses	516,380	(10,065)	1,264,293	661,595
Income (loss) before income taxes	(12,445)	(20,706)	32,350	55,476
Income tax expense (benefit)	(4,616)	(7,638)	10,949	18,927
Net income (loss)	$(7,829)	$(13,068)	$21,401	$36,549
Earnings (loss) per common share	$(0.13)	$(0.22)	$0.35	$0.62
Earnings (loss) per common share - assuming dilution	$(0.13)	$(0.22)	$0.34	$0.59
Weighted average common shares outstanding (in thousands):				
Earnings (loss) per common share	62,504	59,596	60,723	59,429
Earnings (loss) per common share - assuming dilution	65,262	62,698	65,232	62,783

See accompanying notes to unaudited consolidated financial statements.

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)
(Unaudited)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net income (loss)	$(7,829)	$(13,068)	21,401	36,549
Other comprehensive income:				
Change in net unrealized investment gains/losses (1)	202,184	507,702	390,575	570,298
Noncredit component of OTTI losses (1)	1,377	1,880	1,667	3,379
Other comprehensive income before income tax	203,561	509,582	392,242	573,677
Income tax effect related to other comprehensive income	(71,247)	(178,354)	(137,285)	(200,787)
Other comprehensive income	132,314	331,228	254,957	372,890
Comprehensive income	$124,485	$318,160	$276,358	$409,439

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

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Dollars in thousands, except per 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, 2011	$57,837	$468,281	$(3,620)	$ 457,229	$428,952	$ 1,408,679
Net income for period	—	—	—	—	21,401	21,401
Other comprehensive income	—	—	—	254,957	—	254,957
Conversion of $20,770 of subordinated debentures	2,564	17,027	—	—	—	19,591
Allocation of 63,946 shares of common stock by ESOP, including excess income tax benefits	—	32	689	—	—	721
Share-based compensation, including excess income tax benefits	—	5,495	—	—	—	5,495
Issuance of 1,147,440 shares of common stock under compensation plans, including excess income tax benefits	1,147	2,962	—	—	—	4,109
Balance at September 30, 2012	$61,548	$493,797	$(2,931)	$ 712,186	$450,353	$ 1,714,953
Balance at December 31, 2010	$56,968	$454,454	$(4,815)	$ 81,820	$349,620	$938,047
Net income for period	—	—	—	—	36,549	36,549
Other comprehensive income	—	—	—	372,890	—	372,890
Acquisition of 1,250 shares of common stock	(1)	(12)	—	—	—	(13)
Allocation of 78,897 shares of common stock by ESOP, including excess income tax benefits	—	65	850	—	—	915
Share-based compensation, including excess income tax benefits	—	6,575	—	—	—	6,575
Issuance of 888,179 shares of common stock under compensation plans, including excess income tax benefits	888	3,686	—	—	—	4,574
Balance at September 30, 2011	$57,855	$464,768	$(3,965)	$ 454,710	$386,169	$ 1,359,537

See accompanying notes to unaudited consolidated financial statements.

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

	Nine Months Ended September 30, 2012	2011
Operating activities		
Net income	$21,401	$36,549
Adjustments to reconcile net income to net cash provided by operating activities:		
Interest sensitive and index product benefits	527,961	621,317
Amortization of deferred sales inducements	50,359	22,892
Annuity product charges	(65,176)	(57,259)
Change in fair value of embedded derivatives	466,278	(138,225)
Increase in traditional life and accident and health insurance reserves	27,850	70,612
Policy acquisition costs deferred	(287,285)	(342,299)
Amortization of deferred policy acquisition costs	105,086	65,155
Provision for depreciation and other amortization	13,969	14,113
Amortization of discounts and premiums on investments	(75,596)	(115,340)
Realized gains/losses on investments and net OTTI losses recognized in operations	13,470	37,030
Change in fair value of derivatives	(269,404)	205,264
Deferred income taxes	(41,469)	(78,920)
Share-based compensation	4,907	5,591
Change in accrued investment income	(47,938)	(45,147)
Change in income taxes recoverable/payable	9,856	(11,902)
Change in other assets	(5,354)	4,375
Change in other policy funds and contract claims	56,568	152,508
Change in collateral held for derivatives	324,596	(284,870)
Change in other liabilities	3,442	(61,921)
Other	(3,873)	516
Net cash provided by operating activities	829,648	100,039
Investing activities		
Sales, maturities, or repayments of investments:		
Fixed maturity securities - available for sale	1,942,533	3,433,977
Fixed maturity securities - held for investment	2,618,207	—
Equity securities - available for sale	7,604	2,958
Mortgage loans on real estate	341,771	133,560
Derivative instruments	276,227	432,411
Other investments	25,901	91
Acquisition of investments:		
Fixed maturity securities - available for sale	(4,987,848)	(3,685,523)
Fixed maturity securities - held for investment	—	(1,940,163)
Mortgage loans on real estate	(280,749)	(413,536)
Derivative instruments	(280,407)	(295,099)
Other investments	(83,779)	(77,189)
Purchases of property, furniture and equipment	(378)	(4,643)
Net cash used in investing activities	(420,918)	(2,413,156)

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

	Nine Months Ended September 30, 2012	2011
Financing activities		
Receipts credited to annuity and single premium universal life policyholder account balances	$2,878,818	$3,718,010
Coinsurance deposits	(16,364)	(80,932)
Return of annuity policyholder account balances	(1,275,208)	(1,357,892)
Financing fees incurred and deferred	—	(1,566)
Repayment of subordinated debentures	(270)	—
Acquisition of common stock	—	(13)
Excess tax benefits realized from share-based compensation plans	624	1,060
Proceeds from issuance of common stock	4,055	4,461
Change in checks in excess of cash balance	(7,903)	4,537
Net cash provided by financing activities	1,583,752	2,287,665
Increase (decrease) in cash and cash equivalents	1,992,482	(25,452)
Cash and cash equivalents at beginning of period	404,952	597,766
Cash and cash equivalents at end of period	$2,397,434	$572,314
Supplemental disclosures of cash flow information		
Cash paid during period for:		
Interest expense	$20,858	$22,129
Income taxes	41,938	108,800
Non-cash operating activity:		
Deferral of sales inducements	220,784	281,376
Non-cash investing activity:		
Real estate acquired in satisfaction of mortgage loans	14,932	17,358
Mortgage loan on real estate sold	—	1,215
Non-cash financing activities:		
Conversion of subordinated debentures	20,770	—

See accompanying notes to unaudited consolidated financial statements.

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2012
(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, 2012 are not necessarily indicative of the results that may be expected for the year ended December 31, 2012. 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, 2011.

During 2011, we discovered a prior period error related to policy benefit reserves for our single premium immediate annuity products. Accordingly, we made an adjustment in the first quarter of 2011 which resulted in a decrease of policy benefit reserves and a decrease in interest sensitive and index product benefits of $4.2 million. On an after-tax basis, the adjustment resulted in a $2.7 million increase in net income for the nine months ended September 30, 2011.

Adopted Accounting Pronouncements

In October 2010, as a result of a consensus of the Financial Accounting Standards Board ("FASB") Emerging Issues Task Force (EITF), the FASB issued an accounting standards update (ASU) that modifies the definition of the types of costs incurred that can be capitalized in the acquisition of new and renewal insurance contracts. This guidance defines the costs that qualify for deferral as incremental direct costs that result directly from and are essential to successful contract transactions and would not have been incurred by the insurance entity had the contract transactions not occurred. In addition, it lists certain costs as deferrable as those that are directly related to underwriting, policy issuance and processing, medical and inspection, and sales force contract selling as deferrable, as well as the portion of an employee's total compensation related directly to time spent performing those activities for actual acquired contracts and other costs related directly to those activities that would not have been incurred if the contract had not been acquired. This amendment to current GAAP became effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. Other operating costs and expenses for the three and nine months ended September 30, 2012, increased $2.2 million and $7.2 million, respectively, due to the prospective adoption of this ASU effective January 1, 2012, which increased net loss $1.5 million and loss per share $0.02 for three months ended September 30, 2012 and decreased net income $4.6 million and earnings per share $0.07 for the nine months ended September 30, 2012.

In May 2011, the FASB issued an ASU that addresses fair value measurement and disclosure as part of its convergence efforts with the International Accounting Standards Board. The guidance is intended to create common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards. This ASU changes the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. Some changes clarify the FASB's intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The disclosure requirements add information about transfers between Level 1 and Level 2 of the fair value hierarchy, information about the sensitivity of a fair value measurement categorized within Level 3 of the fair value hierarchy to changes in unobservable inputs and any interrelationships between those unobservable inputs and the categorization by level of the fair value

hierarchy for items that are not measured at fair value in the statement of financial position, but for which the fair value of such items is required to be disclosed. This ASU became effective for interim and annual periods beginning after December 15, 2011. See note 2 for disclosures regarding fair value measurements.
In June 2011, the FASB issued an ASU that expands the disclosure requirements related to other comprehensive income (loss). A reporting entity is now required to present the total of comprehensive income (loss), the components of net income, and the components of other comprehensive income (loss) either in a single continuous statement of comprehensive income (loss) or in two separate but consecutive statements. Under both choices, the reporting entity is required to present each component of net income along with total net income, each component of other comprehensive income (loss) along with a total for other comprehensive income (loss) and a total amount for comprehensive income (loss). This ASU became effective for interim and annual periods beginning after December 15, 2011. We adopted this ASU on January 1, 2012.
New Accounting Pronouncements
There are no accounting standards updates finalized to become effective in the future that will significantly affect our consolidated financial statements.

Significant Accounting Policy - Deferred Policy Acquisition Costs

Our accounting policy for deferred policy acquisition costs which follows, has been updated from our Form 10-K for the year ended December 31, 2011 to reflect the adoption of new accounting standards.

To the extent recoverable from future policy revenues and gross profits, certain costs that are incremental or directly related to the successful production of new business are not expensed when incurred but instead are capitalized as deferred policy acquisition costs. Deferred policy acquisition costs are subject to loss recognition testing on a quarterly basis or when an event occurs that may warrant loss recognition. Deferred policy acquisition costs consist primarily of commissions and certain costs of policy issuance.

For annuity products, these capitalized costs are being amortized generally in proportion to expected gross profits from investment spreads, including the cost of hedging the fixed indexed annuity obligations, and, to a lesser extent, from product charges and mortality and expense margins. That amortization is adjusted retrospectively through an unlocking process when estimates of current or future gross profits/margins (including the impact of net realized gains on investments and net OTTI losses recognized in operations) to be realized from a group of products are revised. Deferred policy acquisition costs are also adjusted for the change in amortization that would have occurred if available for sale fixed maturity securities and equity securities had been sold at their aggregate fair value at the end of the reporting period and the proceeds reinvested at current yields. The impact of this adjustment is included in accumulated other comprehensive income within consolidated stockholders' equity, net of applicable taxes.

2. Fair Values of Financial Instruments

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

	September 30, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(Dollars in thousands)			
Assets				
Fixed maturity securities:				
Available for sale	$22,410,492	$22,410,492	$18,464,109	$18,464,109
Held for investment	76,048	63,759	2,644,206	2,644,422
Equity securities, available for sale	61,604	61,604	62,845	62,845
Mortgage loans on real estate	2,724,321	2,969,635	2,823,047	3,030,308
Derivative instruments	577,784	577,784	273,314	273,314
Other investments	162,215	164,902	79,109	76,648
Cash and cash equivalents	2,397,434	2,397,434	404,952	404,952
Coinsurance deposits	2,913,273	2,661,627	2,818,642	2,549,025
Interest rate caps	3,252	3,252	—	—
2015 notes hedges	40,020	40,020	45,593	45,593
Liabilities				
Policy benefit reserves	30,666,825	25,459,927	27,842,770	23,407,540
Single premium immediate annuity (SPIA) benefit reserves	456,331	471,389	397,248	412,998
Notes payable	306,696	398,479	297,608	376,370
Subordinated debentures	245,825	221,626	268,593	233,809
2015 notes embedded derivatives	40,020	40,020	45,593	45,593
Interest rate swap	4,319	4,319	—	—

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.

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

Level 1—	Quoted prices are available in active markets for identical financial instruments as of the reporting date. We do not adjust the quoted price for these financial instruments, even in situations where we hold a large position and a sale could reasonably impact the quoted price.
Level 2—	Quoted prices in active markets for similar financial instruments, quoted prices for identical or similar financial instruments in markets that are not active; and models and other valuation methodologies using inputs other than quoted prices that are observable.
Level 3—	Models and other valuation methodologies using significant inputs that are unobservable for financial instruments and include situations where there is little, if any, market activity for the financial instrument. The inputs into the determination of fair value require significant management judgment or estimation. Financial instruments that are included in Level 3 are securities for which no market activity or data exists and for which we used discounted expected future cash flows with our own assumptions about what a market participant would use in determining fair value.

Transfers of securities among the levels occur at times and depend on the type of inputs used to determine fair value of each security, however there were no transfers between levels during the nine months ended September 30, 2012.

Our assets and liabilities which are measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011 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, 2012				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$5,205	$5,205	$—	$—
United States Government sponsored agencies	1,958,737	—	1,958,737	—
United States municipalities, states and territories	3,571,462	—	3,571,462	—
Foreign government obligations	98,825	—	98,825	—
Corporate securities	13,242,999	38,049	13,204,950	—
Residential mortgage backed securities	2,565,959	—	2,564,087	1,872
Commercial mortgage backed securities	78,912	—	78,912	—
Other asset backed securities	888,393	383	888,010	—
Equity securities, available for sale: finance, insurance and real estate	61,604	44,851	16,753	—
Derivative instruments	577,784	—	577,784	—
Cash and cash equivalents	2,397,434	2,397,434	—	—
Interest rate caps	3,252	—	3,252	—
2015 notes hedges	40,020	—	40,020	—
	$25,490,586	$2,485,922	$23,002,792	$1,872
Liabilities				
2015 notes embedded derivatives	$40,020	$—	$40,020	$—
Interest rate swap	4,319	—	4,319	—
Fixed index annuities - embedded derivatives	3,266,782	—	—	3,266,782
	$3,311,121	$—	$44,339	$3,266,782
December 31, 2011				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$4,678	$4,678	$—	$—
United States Government sponsored agencies	1,799,779	—	1,799,779	—
United States municipalities, states and territories	3,333,383	—	3,333,383	—
Foreign government obligations	43,228	—	43,228	—
Corporate securities	10,116,361	58,827	10,057,534	—
Residential mortgage backed securities	2,703,290	—	2,701,192	2,098
Other asset backed securities	463,390	370	463,020	—
Equity securities, available for sale: finance, insurance and real estate	62,845	44,229	18,616	—
Derivative instruments	273,314	—	273,314	—
Cash and cash equivalents	404,952	404,952	—	—
2015 notes hedges	45,593	—	45,593	—

	$19,250,813	$513,056	$18,735,659	$2,098
Liabilities				
2015 notes embedded derivatives	$45,593	$—	$45,593	$—
Fixed index annuities - embedded derivatives	2,530,496	—	—	2,530,496
	$2,576,089	$—	$45,593	$2,530,496

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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 two broker quotes and take the average of two 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 of 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, 2012 and December 31, 2011.

Mortgage loans on real estate

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

Derivative instruments

The fair values of derivative instruments, primarily call options, are based upon the amount of cash that we will receive to settle each derivative instrument on the reporting date. These amounts are obtained from each of the counterparties 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, an equity method investment 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 value of our equity method investment qualifies as a Level 3 fair value and was 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 whose fair values fall within Level 2 of the fair value hierarchy.

Cash and cash equivalents

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

Interest rate swaps and caps

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

2015 notes hedges

The fair value of these call options is 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.

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

Subordinated debentures

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

2015 notes embedded derivatives

The fair value of this embedded derivative is determined by pricing the call options that hedge this potential liability. The terms of the conversion premium 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, 2012 and 2011:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Available for sale securities				
Beginning balance	$2,005	$2,193	$2,098	$2,702
Principal returned	(101)	(80)	(194)	(346)
(Amortization)/accretion of premium/discount	13	29	60	37
Total gains (losses) (realized/unrealized):				
Included in other comprehensive income (loss)	28	105	211	384
Included in operations	(73)	(152)	(303)	(682)
Ending balance	$1,872	$2,095	$1,872	$2,095

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Fixed index annuities - embedded derivatives				
Beginning balance	$2,914,948	$2,368,533	$2,530,496	$1,971,383
Premiums less benefits	229,340	274,579	418,845	742,255
Change in unrealized gains, net	122,494	(244,015)	317,441	(314,541)
Ending balance	$3,266,782	$2,399,097	$3,266,782	$2,399,097

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

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

The most sensitive assumption in determining policy liabilities for fixed index annuities is the rates used to discount the excess projected contract values. As indicated above, the discount rate reflects our nonperformance risk. If the discount rates used to discount the excess projected contract values at September 30, 2012, were to increase by 100 basis points, the fair value of the embedded derivatives would decrease by $232.6 million recorded through operations as a decrease in the change in fair value of embedded derivatives and there would be a corresponding decrease of $141.6 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 $260.4 million recorded through operations as an increase in the change in fair value of embedded derivatives and increase our combined balance for deferred policy acquisition costs and deferred sales inducements by $159.2 million 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, 2012 and December 31, 2011, 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, 2012				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$4,590	$615	$—	$5,205
United States Government sponsored agencies	1,939,562	19,661	(486)	1,958,737
United States municipalities, states and territories	3,096,008	475,456	(2)	3,571,462
Foreign government obligations	81,126	17,699	—	98,825
Corporate securities	11,652,586	1,617,343	(26,930)	13,242,999
Residential mortgage backed securities	2,433,080	173,881	(41,002)	2,565,959
Commercial mortgage backed securities	78,682	260	(30)	78,912
Other asset backed securities	850,380	39,876	(1,863)	888,393
	$20,136,014	$2,344,791	$(70,313)	$22,410,492
Held for investment:				
Corporate security	$76,048	$—	$(12,289)	$63,759
Equity securities, available for sale:				
Finance, insurance, and real estate	$50,597	$12,164	$(1,157)	$61,604
December 31, 2011				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$4,084	$594	$—	$4,678
United States Government sponsored agencies	1,780,401	19,378	—	1,799,779
United States municipalities, states and territories	2,981,699	351,694	(10)	3,333,383
Foreign government obligations	60,809	7,766	(242)	68,333
Corporate securities	9,092,737	1,078,511	(79,992)	10,091,256
Residential mortgage backed securities	2,618,040	157,331	(72,081)	2,703,290
Other asset backed securities	442,509	26,492	(5,611)	463,390
	$16,980,279	$1,641,766	$(157,936)	$18,464,109
Held for investment:				
United States Government sponsored agencies	$2,568,274	$16,806	$—	$2,585,080
Corporate security	75,932	—	(16,590)	59,342
	$2,644,206	$16,806	$(16,590)	$2,644,422
Equity securities, available for sale:				
Finance, insurance, and real estate	$58,438	$8,752	$(4,345)	$62,845

During the nine months ended September 30, 2012 and 2011, we received $3.8 billion and $2.9 billion, respectively, in redemption proceeds related to calls of our callable United States Government sponsored agency securities and public and private corporate bonds, of which $2.6 billion for the nine months ended September 30, 2012 were classified as held for investment . There were no calls of held for investment securities during the nine months ended September 30, 2011. The proceeds from these redemptions that have been reinvested have primarily been in United States government sponsored agencies, corporate securities, commercial mortgage backed securities and other asset backed securities. For the remaining amount to be reinvested we are considering further diversification into other asset classes, but we remain committed to maintaining a high quality investment portfolio with low credit risk. At

September 30, 2012, 30% of our fixed income securities have call features and 1% ($0.1 billion) were subject to call redemption. Another 10% ($1.9 billion) will become subject to call redemption during the next twelve months (principally the last quarter of 2012 and the second quarter of 2013).

The amortized cost and fair value of fixed maturity securities at September 30, 2012, 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	$41,968	$43,181	$—	$—
Due after one year through five years	623,552	700,154	—	—
Due after five years through ten years	3,868,878	4,262,988	—	—
Due after ten years through twenty years	5,294,593	5,820,676	—	—
Due after twenty years	6,944,881	8,050,229	76,048	63,759
	16,773,872	18,877,228	76,048	63,759
Residential mortgage backed securities	2,433,080	2,565,959	—	—
Commercial mortgage backed securities	78,682	78,912	—	—
Other asset backed securities	850,380	888,393	—	—
	$20,136,014	$22,410,492	$76,048	$63,759

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, 2012	December 31, 2011
	(Dollars in thousands)	
Net unrealized gains on available for sale fixed maturity securities and equity securities	$2,285,485	$1,488,237
Adjustments for assumed changes in amortization of deferred policy acquisition costs and deferred sales inducements	(1,224,482)	(819,476)
Deferred income tax valuation allowance reversal	22,534	22,534
Deferred income tax benefit	(371,351)	(234,066)
Net unrealized gains reported as accumulated other comprehensive income	$712,186	$457,229

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, 2012 and December 31, 2011.

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

	September 30, 2012		December 31, 2011	
NAIC Designation	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
1	$13,007,318	$14,591,003	$14,359,272	$15,486,571
2	6,846,088	7,538,539	4,894,739	5,272,759
3	319,697	304,463	335,642	315,406
4	31,719	32,361	26,674	23,989
5	4,451	4,006	4,932	5,756
6	2,789	3,879	3,226	4,050

$20,212,062	$22,474,251	$19,624,485	$21,108,531

The following tables show our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities (consisting of 150 and 246 securities, respectively) have been in a continuous unrealized loss position, at September 30, 2012 and December 31, 2011:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
September 30, 2012						
Fixed maturity securities:						
Available for sale:						
United States Government sponsored agencies	$483,280	$(486)	$—	$—	$483,280	$(486)
United States municipalities, states and territories	271	(2)	—	—	271	(2)
Corporate securities:						
Finance, insurance and real estate	139,777	(2,670)	130,932	(10,981)	270,709	(13,651)
Manufacturing, construction and mining	118,741	(1,445)	20,948	(2,315)	139,689	(3,760)
Utilities and related sectors	63,822	(549)	50,043	(7,868)	113,865	(8,417)
Wholesale/retail trade	12,368	(447)	9,900	(561)	22,268	(1,008)
Services, media and other	5,929	(94)	—	—	5,929	(94)
Residential mortgage backed securities	168,342	(7,091)	404,344	(33,911)	572,686	(41,002)
Commercial mortgage backed securities	18,419	(30)	—	—	18,419	(30)
Other asset backed securities	25,250	(448)	31,027	(1,415)	56,277	(1,863)
	$1,036,199	$(13,262)	$647,194	$(57,051)	$1,683,393	$(70,313)
Held for investment:						
Corporate security:						
Insurance	$—	$—	$63,759	$(12,289)	$63,759	$(12,289)
Equity securities, available for sale:						
Services, media and other	$8,968	$(1,157)	$—	$—	$8,968	$(1,157)
December 31, 2011						
Fixed maturity securities:						
Available for sale:						
United States municipalities, states and territories	$3,535	$(10)	$—	$—	$3,535	$(10)
Foreign government obligations	—	—	14,282	(242)	14,282	(242)
Corporate securities:						
Finance, insurance and real estate	363,909	(36,575)	146,354	(15,611)	510,263	(52,186)
Manufacturing, construction and mining	201,762	(7,131)	15,593	(1,627)	217,355	(8,758)
Utilities and related sectors	174,251	(7,576)	37,778	(6,946)	212,029	(14,522)
Wholesale/retail trade	15,523	(188)	9,275	(1,194)	24,798	(1,382)
Services, media and other	27,688	(249)	17,105	(2,895)	44,793	(3,144)
Residential mortgage backed securities	295,352	(19,920)	709,612	(52,161)	1,004,964	(72,081)
Other asset backed securities	115,542	(2,863)	15,550	(2,748)	131,092	(5,611)
	$1,197,562	$(74,512)	$965,549	$(83,424)	$2,163,111	$(157,936)

Held for investment:						
Corporate security:						
Insurance	$—	$—	$59,342	$(16,590)	$59,342	$(16,590)
Equity securities, available for sale:						
Finance, insurance and real estate	$20,028	$(3,095)	$3,750	$(1,250)	$23,778	$(4,345)

The following is a description of the factors causing the temporary unrealized losses by investment category as of September 30, 2012:

United States Government sponsored agencies and United States municipalities, states and territories: These securities are relatively long in duration; however, they are callable in less than 12 months making the value of such securities sensitive to changes in market interest rates. The timing of when some of these securities were purchased in 2012 gave rise to unrealized losses at September 30, 2012.

Corporate securities: The unrealized losses in these securities are due partially to the timing of purchases in 2012 and a small number of securities seeing their credit spreads remain wide due to issuer or industry specific news. In addition, some financial and industrial sector credit spreads remain wide due to continued economic uncertainty and concerns of economic instability in the European Union.

Residential mortgage backed securities: At September 30, 2012, we had no exposure to sub-prime residential mortgage backed securities. All of our residential mortgage backed securities are pools of first-lien residential mortgage loans. Substantially all of the securities that we own are in the most senior tranche of the securitization in which they are structured and are not subordinated to any other tranche. Our "Alt-A" residential mortgage backed securities are comprised of 36 securities with a total amortized cost basis of $389.9 million and a fair value of $380.9 million. Despite recent improvements in the capital markets, the fair values of RMBS continue at prices below amortized cost. RMBS prices will likely remain below our cost basis until the housing market is able to absorb current and future foreclosures.

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. Only one security in an unrealized loss position is rated below investment grade.

Equity securities: Equity securities in an unrealized loss position consist of a perpetual preferred security of an industrial company. Despite modest deterioration of its business profile our view for the investment over the intermediate term is constructive.

Approximately 90% and 83% of the unrealized losses on fixed maturity securities shown in the above table for September 30, 2012 and December 31, 2011, respectively, are on securities that are rated investment grade, defined as being the highest two NAIC designations. All of the securities with unrealized losses, except one security with a principal amount outstanding of $4.5 million and an unrealized loss of $0.4 million, are current with respect to the payment of principal and interest.

Changes in net unrealized gains/losses on investments for the three and nine months ended September 30, 2012 and 2011 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
			(Dollars in thousands)	
Fixed maturity securities held for investment carried at amortized cost	$(626)	$22,325	$(12,505)	$51,727
Investments carried at fair value:				
Fixed maturity securities, available for sale	$402,274	$1,094,823	$790,648	$1,245,506
Equity securities, available for sale	2,963	(1,212)	6,600	1,428
	405,237	1,093,611	797,248	1,246,934
Adjustment for effect on other balance sheet accounts:				
Deferred policy acquisition costs and deferred sales inducements	(201,676)	(584,029)	(405,006)	(673,257)
Deferred income tax asset	(71,247)	(178,354)	(137,285)	(200,787)
	(272,923)	(762,383)	(542,291)	(874,044)
Increase in net unrealized gains on investments carried at fair value	$132,314	$331,228	$254,957	$372,890

Proceeds from sales of available for sale securities for the nine months ended September 30, 2012 and 2011 were $276.1 million and $144.4 million, respectively. Scheduled principal repayments, calls and tenders for available for sale securities for the nine months ended September 30, 2012 and 2011 were $1.6 billion and $3.3 billion, respectively.

Realized gains and losses on sales are determined on the basis of specific identification of investments based on the trade date. Net realized gains (losses) on investments, excluding net OTTI losses for the three and nine months ended September 30, 2012 and 2011 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			

Available for sale fixed maturity securities:				
Gross realized gains	$3,028	$169	$8,076	$4,711
Gross realized losses	(180)	—	(535)	(1,423)
	2,848	169	7,541	3,288
Equity securities:				
Gross realized gains	—	—	562	966
Other investments:				
Gain (loss) on sale of real estate	53	—	2,948	—
Impairment losses on real estate	(830)	—	(3,473)	(12)
	(777)	—	(525)	(12)
Mortgage loans on real estate:				
Increase in allowance for credit losses	(3,309)	(17,461)	(15,503)	(23,581)
	$(1,238)	$(17,292)	$(7,925)	$(19,339)

We review and analyze all investments on an ongoing basis for changes in market interest rates and credit deterioration. This review process includes analyzing our ability to recover the amortized cost basis of each investment that has a fair value that is materially lower than its amortized cost and requires a high degree of management judgment and involves uncertainty. The evaluation of securities for other than temporary impairments is a quantitative and qualitative process, which is subject to risks and uncertainties. We have a policy and process in place to identify securities that could potentially have impairments that are other than temporary. This process involves monitoring market events and other items that could impact issuers. The evaluation includes but is not limited to such factors as:

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

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

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

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

The determination of the credit loss component of a residential 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, 2012 and 2011, which are all senior level tranches within the structure of the securities:

		Discount Rate				Default Rate				Loss Severity			
Sector	Vintage	Min		Max		Min		Max		Min		Max	
Nine months ended September 30, 2012													
Prime	2005	6.5	%	7.7	%	9	%	18	%	50	%	50	%
	2006	5.8	%	7.4	%	9	%	19	%	40	%	55	%
	2007	6.2	%	7.3	%	11	%	38	%	40	%	60	%
Alt-A	2005	5.6	%	8.7	%	12	%	27	%	5	%	55	%
	2006	6.0	%	6.0	%	32	%	46	%	55	%	60	%
	2007	6.2	%	7.0	%	31	%	55	%	55	%	60	%
Nine months ended September 30, 2011													
Prime	2005	5.8	%	7.7	%	6	%	13	%	45	%	55	%
	2006	6.4	%	7.6	%	8	%	14	%	45	%	60	%
	2007	5.8	%	7.9	%	8	%	30	%	40	%	60	%
Alt-A	2005	5.8	%	7.7	%	11	%	25	%	5	%	55	%
	2006	6.0	%	6.5	%	23	%	33	%	50	%	55	%
	2007	6.2	%	7.4	%	29	%	41	%	50	%	70	%

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

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

The following table summarizes other than temporary impairments for the three and nine months ended September 30, 2012 and 2011, 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, 2012				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	4	$—	$ (1,686)	$(1,686)
Three months ended September 30, 2011				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	37	$(5,133)	$ (3,758)	$(8,891)
Nine months ended September 30, 2012				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	24	$(2,156)	$ (3,389)	$(5,545)
Nine months ended September 30, 2011				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	47	$(10,346)	$ (7,345)	$(17,691)

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,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Cumulative credit loss at beginning of period	$(122,954)	$(104,480)	$(119,095)	$(96,893)
Credit losses on securities for which OTTI has not previously been recognized	—	(1,243)	(47)	(2,032)
Additional credit losses on securities for which OTTI has previously been recognized	(1,686)	(7,648)	(5,498)	(15,659)
Accumulated losses on securities that were disposed of during the period	—	—	—	1,213
Cumulative credit loss at end of period	$(124,640)	$(113,371)	$(124,640)	$(113,371)

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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, by major type of security, for securities that are part of our investment portfolio at September 30, 2012 and December 31, 2011:

	Amortized Cost	OTTI Recognized in Other Comprehensive Income	Change in Fair Value Since OTTI was Recognized	Fair Value
	(Dollars in thousands)			
September 30, 2012				
Fixed maturity securities, available for sale:				
Corporate securities	$3,515	$(2,151)	$5,651	$7,015
Residential mortgage backed securities	899,116	(183,737)	166,604	881,983
Equity securities, available for sale:				
Finance, insurance and real estate	9,976	—	11,501	21,477
	$912,607	$(185,888)	$183,756	$910,475
December 31, 2011				
Fixed maturity securities, available for sale:				
Corporate securities	$3,347	$(2,151)	$4,818	$6,014
Residential mortgage backed securities	999,024	(187,126)	125,502	937,400
Equity securities, available for sale:				
Finance, insurance and real estate	12,019	—	8,110	20,129
	$1,014,390	$(189,277)	$138,430	$963,543

4. Mortgage Loans on Real Estate

Our mortgage loan portfolio totaled $2.7 billion and $2.8 billion at September 30, 2012 and December 31, 2011, respectively, with commitments outstanding of $48.9 million at September 30, 2012.

	September 30, 2012	December 31, 2011
	(Dollars in thousands)	
Principal outstanding	$2,762,861	$2,856,011
Loan loss allowance	(38,022)	(32,964)
Deferred prepayment fees	(518)	—
Carrying value	$2,724,321	$2,823,047

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, 2012			December 31, 2011		
	Principal Outstanding	Percent		Principal Outstanding	Percent	
	(Dollars in thousands)					
Geographic distribution						
East	$719,407	26.0	%	$719,231	25.2	%
Middle Atlantic	156,828	5.7	%	169,240	5.9	%
Mountain	404,803	14.7	%	411,054	14.4	%
New England	26,763	1.0	%	36,815	1.3	%
Pacific	325,936	11.8	%	309,693	10.8	%
South Atlantic	500,232	18.1	%	493,764	17.3	%
West North Central	406,511	14.7	%	487,693	17.1	%
West South Central	222,381	8.0	%	228,521	8.0	%
	$2,762,861	100.0	%	$2,856,011	100.0	%
Property type distribution						
Office	$702,796	25.5	%	$777,343	27.2	%
Medical Office	143,971	5.2	%	175,580	6.1	%
Retail	699,190	25.3	%	635,916	22.3	%
Industrial/Warehouse	699,690	25.3	%	710,426	24.9	%
Hotel	106,596	3.9	%	139,193	4.9	%
Apartment	208,099	7.5	%	187,548	6.6	%
Mixed use/other	202,519	7.3	%	230,005	8.0	%
	$2,762,861	100.0	%	$2,856,011	100.0	%

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

Our financing receivables currently consist of one portfolio segment which is our commercial mortgage loan portfolio. These are mortgage loans with collateral consisting of commercial real estate and borrowers consisting mostly of limited liability partnerships or limited liability corporations. Credit loss experience in our mortgage loan portfolio has been limited to the most recent fiscal years. We experienced our first credit loss from our commercial mortgage loan portfolio in 2009.

Since 2008, we have had a population of mortgage loans that we have been carrying with workout terms (e.g. interest only periods, period of suspended payments, etc.) and a population of mortgage loans that have been in a delinquent status (i.e. more than 60 days past due). It is from this population that we have been recognizing some impairment loss due to nonpayment and eventual satisfaction of the loan by taking ownership of the collateral real estate. In most cases the fair value of the collateral less estimated costs to sell such collateral has been less than the outstanding principal amount of the mortgage loan.

Our general loan loss allowance for periods through September 30, 2011 was calculated on the cumulative outstanding principal on loans making up the group of loans currently in workout terms and loans currently more than 60 days past due. We applied a factor to the total outstanding principal of these loans that was calculated as the average specific impairment loss for the most recent 4 quarters divided by the sum of the average of the total outstanding principal of delinquent loans for the most recent 4 quarters and the average of the total outstanding principal of loans in workout for the most recent 4 quarters. In the fourth quarter of 2011, we modified the calculation for determining our general loan loss allowance. The group of loans that we calculated an estimate of general loan loss allowance were those that had a debt service coverage ratio (DSCR) of less than 1.0. The DSCR is calculated by dividing the net operating income of the mortgaged property by the contractual principal and interest payment due for the corresponding period. We developed the loss rates to apply to this group of loans by dividing the specific impairment loss for the most recent 4 quarters by the principal outstanding of the loans with a DSCR of less than 1.0.

In the third quarter of 2012, we completed a process of rating the mortgage loans in our portfolio based on factors such as historical operating performance, loan to value ratio and economic outlook, among others. We calculated a loss factor to apply to each rating based on historical losses we have recognized in our mortgage loan portfolio. We applied the loss factors to the total principal outstanding within each rating category to determine an appropriate estimate of general loan loss allowance at September 30, 2012. The change in methodology utilized to determine the general loan loss allowance did not result a material adjustment.

The following table presents a rollforward of our specific and general valuation allowances for commercial mortgage loans for the three and nine months ended September 30, 2012 and 2011:

	Three months ended September 30, 2012		Three months ended September 30, 2011	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	$(25,445)	$(11,200)	$(15,027)	$(4,200)
Charge-offs	1,932	—	5,877	—
Recoveries	—	—	—	—
Provision for credit losses	(2,909)	(400)	(15,961)	(1,500)
Ending allowance balance	$(26,422)	$(11,600)	$(25,111)	$(5,700)

	Nine months ended September 30, 2012		Nine months ended September 30, 2011	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	$(23,664)	$(9,300)	$(13,224)	$(3,000)
Charge-offs	10,445	—	8,994	—
Recoveries	—	—	—	—
Provision for credit losses	(13,203)	(2,300)	(20,881)	(2,700)
Ending allowance balance	$(26,422)	$(11,600)	$(25,111)	$(5,700)

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

	September 30, 2012	December 31, 2011
	(Dollars in thousands)	
Individually evaluated for impairment	$96,586	$130,721
Collectively evaluated for impairment	2,666,275	2,725,290
Total loans evaluated for impairment	$2,762,861	$2,856,011

The amount of loans collectively evaluated for impairment at December 31, 2011 was modified from what was originally reported to reflect a more appropriate amount of financing receivables that were evaluated collectively.

The amount of charge-offs include the amount of allowance that has been established for loans that were satisfied by taking ownership of the collateral. When the property is taken it is recorded at its fair value and the mortgage loan is recorded as fully paid, with any allowance for credit loss that has been established charged off. There could be other situations that develop where we have established a larger specific loan loss allowance than is needed based on increases in the fair value of collateral supporting collateral dependent loans, or improvements in the financial position of a borrower so that a loan would become reliant on cash flows from debt service instead of dependent upon sale of the collateral. Charge-offs of the allowance would be recognized in those situations as well. We define collateral dependent loans as those mortgage loans for which we will depend on the value of the collateral real estate to satisfy the outstanding principal of the loan. See note 2 for how we determine the value of the collateral real estate.

During the three and nine months ended September 30, 2012, two and eight mortgage loans, respectively, were satisfied by taking ownership of the real estate serving as collateral compared to six and nine mortgage loans, respectively, for the same periods in 2011. The following table summarizes the activity in the real estate owned which was obtained in satisfaction of mortgage loans on real estate:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Real estate owned at beginning of period	$38,390	$23,910	$36,821	$19,122
Real estate acquired in satisfaction of mortgage loans	2,916	11,049	14,902	17,357
Additions	—	39	117	79
Sales	(5,727)	—	(13,093)	(1,283)
Impairments	(830)	—	(3,473)	—
Depreciation	(185)	(173)	(710)	(450)
Real estate owned at end of period	$34,564	$34,825	$34,564	$34,825

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, 2012	December 31, 2011
	(Dollars in thousands)	
Credit Exposure--By Payment Activity		
Performing	$2,682,471	$2,743,068
In workout	44,371	67,425
Delinquent	—	6,595
Collateral dependent	36,019	38,923
	$2,762,861	$2,856,011

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, 2012 and December 31, 2011 totaled $36.0 million and $45.5 million, respectively.

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

Aging of financing receivables 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, 2012	$—	$—	$—	$—	$2,726,842	$ 36,019	$2,762,861
December 31, 2011	$3,378	$—	$6,595	$9,973	$2,807,115	$ 38,923	$2,856,011

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

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)				
September 30, 2012					
Mortgage loans with specific allowance	$39,629	$66,051	$(26,422)	$48,873	$1,970
Mortgage loans with no specific allowance	30,535	30,535	—	30,211	1,479
	$70,164	$96,586	$(26,422)	$79,084	$3,449
December 31, 2011					
Mortgage loans with specific allowance	$44,034	$67,698	$(23,664)	$53,617	$3,284
Mortgage loans with no specific allowance	63,023	63,023	—	60,974	3,509
	$107,057	$130,721	$(23,664)	$114,591	$6,793

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

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

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Mortgage loan workouts, refinances or restructures that are classified as TDR are individually evaluated and measured for impairment. A summary of mortgage loans on commercial real estate with outstanding principal at September 30, 2012 and December 31, 2011 that we determined to be TDR's are as follows:

Geographic Region	Number of TDR's	Principal Balance Outstanding	Specific Loan Loss Allowance	Net Carrying Amount
		(Dollars in thousands)		
September 30, 2012				
East	1	$4,208	$(1,425)	$2,783
Mountain	10	32,222	(2,193)	30,029
South Atlantic	7	20,690	(4,309)	16,381
East North Central	4	11,914	(4,116)	7,798
West North Central	2	6,974	(1,300)	5,674
	24	$76,008	$(13,343)	$62,665
December 31, 2011				
East	3	$8,489	$(2,115)	$6,374
Mountain	10	29,539	(1,637)	27,902
South Atlantic	11	28,676	(6,339)	22,337
West North Central	1	1,937	(269)	1,668
	25	$68,641	$(10,360)	$58,281

5. Derivative Instruments

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

	September 30, 2012	December 31, 2011
	(Dollars in thousands)	
Assets		
Derivative instruments		
Call options	$577,784	$273,314
Other assets		
2015 notes hedges	40,020	45,593
Interest rate caps	3,252	—
	$621,056	$318,907
Liabilities		
Policy benefit reserves - annuity products		
Fixed index annuities - embedded derivatives	$3,266,782	$2,530,496
Other liabilities		
2015 notes embedded derivatives	40,020	45,593
Interest rate swap	4,319	—
	$3,311,121	$2,576,089

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Change in fair value of derivatives:				
Call options	$160,735	$(292,167)	$280,014	$(161,953)
2015 notes hedges	1,839	(41,446)	(5,573)	(44,900)
Interest rate swaps	(1,171)	(8)	(4,319)	(144)
Interest rate caps	(313)	—	(718)	—
	$161,090	$(333,621)	$269,404	$(206,997)
Change in fair value of embedded derivatives:				
2015 notes embedded derivatives	$1,839	$(41,446)	$(5,573)	$(44,900)
Fixed index annuities	186,362	(164,119)	471,851	(93,325)
	$188,201	$(205,565)	$466,278	$(138,225)

We have fixed index annuity products that guarantee the return of principal to the policyholder and credit interest based on a percentage of the gain in a specified market index. When fixed index annuity deposits are received, a portion of the deposit is used to purchase derivatives consisting of call options on the applicable market indices to fund the index credits due to fixed index annuity policyholders. Substantially all such call options are one year options purchased to match the funding requirements of the underlying policies. The call options are marked to fair value with the change in fair value included as a component of revenues. The change in fair value of derivatives includes the gains or losses recognized at the expiration of the option term or upon early termination and the changes in fair value for open positions. On the respective anniversary dates of the index policies, the index used to compute the annual index credit is reset and we purchase new one-year call options to fund the next annual index credit. We manage the cost of these purchases through the terms of our fixed index annuities, which permit us to change caps, participation rates, and/or asset fees, subject to guaranteed minimums on each policy's anniversary date. By adjusting caps, participation rates, or asset fees, we can generally manage option costs except in cases where the contractual features would prevent further modifications.

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

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

Counterparty	Credit Rating (S&P)	Credit Rating (Moody's)	September 30, 2012 Notional Amount	Fair Value	December 31, 2011 Notional Amount	Fair Value
			(Dollars in thousands)			
Bank of America	A	A3	$878,916	$44,463	$2,340,213	$43,481
Barclays	A+	A2	3,114,784	120,239	2,419,339	60,903
BNP Paribas	AA-	A2	2,302,476	92,564	2,533,301	48,293
Citibank, N.A.	A	A3	2,592,111	70,255	—	—
Credit Suisse	A+	A1	842,294	36,414	1,423,802	27,464
Deutsche Bank	A+	A2	832,802	31,926	384,420	7,697
HSBC	AA-	Aa3	210,029	7,361	348,674	4,557
J.P. Morgan	A+	Aa3	1,095,703	47,724	2,109,019	27,961
Morgan Stanley	A	Baa1	1,164,516	45,362	244,180	7,375
UBS	A	A2	282	20	39,147	240
Wells Fargo (Wachovia)	AA-	Aa3	1,897,578	81,456	2,227,235	45,343
			$14,931,491	$577,784	$14,069,330	$273,314

As of September 30, 2012 and December 31, 2011, we held $490.0 million and $165.4 million, respectively, of cash and cash equivalents received from counterparties for derivative collateral, which is included in other liabilities on our consolidated balance sheets. This derivative collateral limits the maximum amount of loss due to credit risk that we would incur if parties to the call options failed to perform according to the terms of the contracts to $95.2 million and $109.3 million at September 30, 2012 and December 31, 2011, respectively.

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

We enter into interest rate swaps and 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, 2011 for more information on our subordinated debentures. The terms of the interest rate swaps 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 to 2.50%. The interest rate swaps and caps are not effective hedges under accounting guidance for derivative instruments and hedging activities. Therefore, we record the interest rate swaps 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 swaps are as follows:

Maturity Date	Notional Amount	Receive Rate	Pay Rate	Counterparty	September 30, 2012 Fair Value	December 31, 2011 Fair Value
					(Dollars in thousands)	
March 15, 2021	$85,500	*LIBOR	2.415 %	SunTrust	$(4,319)	$—

* - three month London Interbank Offered Rate

Details regarding the interest rate caps are as follows:

Maturity Date	Notional Amount	Floating Rate	Cap Rate	Counterparty	September 30, 2012 Fair Value	December 31, 2011 Fair Value

(Dollars in thousands)

July 7, 2021	$40,000