

[PRINCIPAL FINANCIAL GROUP LOGO]

100,000,000 Shares  
PRINCIPAL FINANCIAL GROUP, INC.  
Common Stock

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This is an initial public offering of 100,000,000 shares of common stock of Principal Financial Group, Inc. This offering is being made in connection with the conversion of Principal Mutual Holding Company from a mutual insurance holding company into a stock company in a process called a demutualization. After the demutualization, Principal Financial Group, Inc. will indirectly own all of the outstanding common stock of Principal Life Insurance Company.

This prospectus relates to an offering of 85,000,000 shares in the United States. In addition, 15,000,000 shares are being offered outside the United States in an international offering.

In addition to these shares, Principal Financial Group, Inc. will issue an estimated 260.6 million shares of its common stock to policyholders entitled to receive shares in the demutualization in exchange for their membership interests in Principal Mutual Holding Company, or to a separate account for the benefit of those policyholders.

Prior to this offering there has been no public market for the common stock. The common stock of Principal Financial Group, Inc. has been approved for listing on the New York Stock Exchange under the symbol "PFG", subject to official notice of issuance.

See "Risk Factors" on page 12 to read about factors you should consider before buying shares of the common stock.

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NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY OTHER REGULATORY BODY HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

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	Per Share	Total
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Initial public offering price.....	\$ 18.50	\$1,850,000,000
Underwriting discount.....	\$ 0.805	\$ 80,475,000
Proceeds, before expenses, to Principal Financial Group, Inc. ....	\$17.695	\$1,769,525,000

To the extent the U.S. underwriters sell more than 85,000,000 shares of common stock, the U.S. underwriters have the option to purchase up to an additional 12,750,000 shares from Principal Financial Group, Inc. at the initial public offering price less the underwriting discount. The international underwriters have a similar option to purchase up to 2,250,000 additional shares of common stock.

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The underwriters expect to deliver the shares against payment in New York, New York on October 26, 2001.

GOLDMAN, SACHS & CO.

CREDIT SUISSE FIRST BOSTON  
MERRILL LYNCH & CO.  
SALOMON SMITH BARNEY

BANC OF AMERICA SECURITIES LLC  
A.G. EDWARDS & SONS, INC.  
JPMORGAN  
RAMIREZ & CO., INC.

BEAR, STEARNS & CO. INC.  
FOX-PITT, KELTON  
LEHMAN BROTHERS  
UBS WARBURG

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Prospectus dated October 22, 2001.

## PROSPECTUS SUMMARY

This summary highlights information contained in this prospectus. As a result, it does not contain all of the information that you should consider before investing in our common stock. You should read the entire prospectus carefully, including the "Risk Factors" section and the consolidated financial statements and the notes to those statements. References to "\$", "US\$" or "dollars" are to United States dollars, and references to "A\$" are to Australian dollars, unless we indicate otherwise. The Glossary beginning on page G-1 of this prospectus includes definitions of certain terms which are unique to this offering. Each term defined in the Glossary is printed in boldface the first time it appears in this prospectus.

The Principal Financial Group is a leading provider of retirement savings, investment and insurance products and services, with \$116.9 billion in assets under management and approximately thirteen million customers worldwide as of June 30, 2001. Our U.S. and international operations concentrate primarily on asset management and accumulation. In addition, we offer a broad range of individual life and disability insurance, group life and health insurance, and residential mortgage loan origination and servicing in the United States.

We focus on providing retirement products and services to businesses and their employees. We provided services to more 401(k) plans in the United States in 2000 than any other bank, mutual fund or insurance company, according to surveys conducted by CFO magazine. We also had the leading market share in 2000 within the 401(k) market for businesses with less than 500 employees based on number of plans and number of participants according to the Spectrem Group.

We believe there are attractive growth opportunities in the 401(k) and other defined contribution pension plan markets in the United States and internationally. Assets under all 401(k) plans in the United States are projected to grow at an annual rate of 14.0%, reaching \$3.2 trillion in plan assets by 2006. In addition, only 18% of U.S. businesses with fewer than 500 employees offered a 401(k) plan in 2000, compared to 87% for businesses with 500 or more employees. We believe that our expertise and leadership in serving the U.S. pension plan market give us a unique competitive advantage in the United States, as well as in countries with a trend toward private sector defined contribution pension systems.

### OUR OPERATING SEGMENTS

We organize our businesses into four operating segments:

- U.S. Asset Management and Accumulation;
- International Asset Management and Accumulation;
- Life and Health Insurance; and
- Mortgage Banking.

We also have a Corporate and Other segment which consists of the assets and activities that have not been allocated to any other segment.

One of the primary measures of our business is assets under management. We define assets under management to include all assets on which we earn an asset-based fee or a spread. Further, we measure the composition of assets under management both by the segment that accumulates the assets and by the entity that manages the assets. The table below shows the composition of assets under management by both measures:

COMPOSITION OF ASSETS UNDER MANAGEMENT  
AS OF JUNE 30, 2001

	ASSET MANAGER(2)				TOTAL ASSETS UNDER MANAGEMENT
	PRINCIPAL CAPITAL MANAGEMENT	BT FINANCIAL GROUP	OTHER ENTITIES OF THE PRINCIPAL FINANCIAL GROUP(3)		
			THIRD-PARTY ASSET MANAGERS		
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(\$ IN BILLIONS)					
ASSET ACCUMULATION SOURCE(1)					
U.S. Asset Management and Accumulation.....	\$71.9	\$ --	\$1.0	\$5.8	\$ 78.7
International Asset Management and Accumulation..	0.1	21.1	3.1	1.4	25.7
Life and Health Insurance.....	9.3	--	--	0.2	9.5
Mortgage Banking.....	--	--	0.3	--	0.3
Corporate and Other.....	2.7	--	--	--	2.7
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Total.....	\$84.0	\$21.1	\$4.4	\$7.4	\$116.9
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(1) We define "asset accumulation" as the sale of investment-oriented products and services for which we provide administrative services and/or offer investment choices.

(2) We define "asset management" as the provision of investment advisory services. We refer to the entity that provides these services as the "asset manager."

(3) Principal Residential Mortgage, Inc., Principal International and Principal Bank.

U.S. ASSET MANAGEMENT AND ACCUMULATION. Our U.S. Asset Management and Accumulation segment consists of our asset accumulation operations which provide products and services, including retirement savings and related investment products and services, and our asset management operations conducted through Principal Capital Management, our U.S.-based asset manager. We provide a comprehensive portfolio of asset accumulation products and services to businesses and individuals in the United States, with a concentration on small and medium-sized businesses, which we define as businesses with less than 1,000 employees. We offer to businesses products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans and non-qualified executive benefit plans. We also offer annuities, mutual funds and bank products and services to the employees of our business customers and other individuals.

Principal Capital Management provides asset management services to our U.S. asset accumulation businesses and third-party institutional clients, as well as our other segments. We established Principal Capital Management in 1999 to consolidate our extensive investment management expertise and to focus on marketing our asset management services to third-party institutional clients. We believe that Principal Capital Management is well-positioned to compete in this third-party institutional market through its expertise gained from managing a significant percentage of the assets originating from our U.S. asset accumulation operations. As of June 30, 2001, Principal Capital Management managed \$84.0 billion in assets.

INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION. Our International Asset Management and Accumulation segment consists of BT Financial Group and Principal International. Our acquisition of BT Financial Group in 1999 was a central element in the expansion of our international asset management and accumulation businesses. As of June 30, 2001, BT Financial Group was the fifth largest asset manager in Australia according to ASSIRT. As of June 30, 2001, BT Financial Group managed \$21.1 billion in assets. We believe that the mandated retirement savings system in Australia, called superannuation, and BT Financial Group's strong market position, together with the expertise we have developed in the U.S. pension market, should provide for growth in our assets under management in Australia. The activities of Principal International reflect our efforts to capitalize on the trend toward private sector defined contribution pension systems. Through Principal International, we offer retirement products and services, annuities, mutual funds and life insurance. We operate through subsidiaries in Argentina, Chile, Mexico and Hong Kong and joint ventures in Brazil, Japan and India.

LIFE AND HEALTH INSURANCE. Our Life and Health Insurance segment offers individual life and disability insurance as well as group life and health insurance throughout the United States. Our individual life and disability insurance business served approximately 750,000 policyholders with \$81.8 billion of life insurance in force as of June 30, 2001. Our individual insurance products include interest-sensitive life, traditional life and disability insurance. Our group insurance business served approximately 80,000 employers covering approximately 5.0 million members and had \$70.7 billion of group life insurance in force as of June 30, 2001. Our group insurance products include life, disability, medical, dental and vision insurance, and administrative services.

MORTGAGE BANKING. Our Mortgage Banking segment engages in originating, purchasing, selling and servicing residential mortgage loans in the United States. We service a majority of the loans that we originate. We originated or purchased \$15.4 billion in new mortgage loans for the six months ended June 30, 2001 compared to \$8.3 billion for the year ended December 31, 2000. We serviced a portfolio of \$64.4 billion of mortgage loans as of June 30, 2001. Residential mortgages represent a component of our overall portfolio of market-driven financial products and services.

#### OUR STRATEGIES AND OPERATING PRINCIPLES

We seek to enhance stockholder value by pursuing the most attractive financial services opportunities consistent with the capabilities of our asset management and accumulation operations. We intend to accomplish this goal by increasing the growth and profitability of these businesses through the pursuit of the following primary strategic initiatives:

**ACCELERATE THE GROWTH OF OUR U.S. ASSET ACCUMULATION BUSINESS.** We intend to strengthen our existing distribution channels and expand into new distribution channels, further leverage our technology to achieve operating efficiencies, continue to expand the range of investment options and effectively cross-sell our products and services.

**INCREASE THE GROWTH AND PROFITABILITY OF OUR INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION BUSINESS.** We will continue to leverage our U.S. product expertise and operating platform to strengthen our international operations. We seek to accelerate the growth of our assets under management by capitalizing on the international trend toward privatization of public retirement pension systems. In addition, we intend to continue our progress in managing expenses.

**GROW OUR THIRD-PARTY INSTITUTIONAL ASSETS UNDER MANAGEMENT.** We selectively target asset classes and customers in the United States, Australia and globally to capitalize on the specific strengths of Principal Capital Management and BT Financial Group. They jointly execute this strategy in their respective markets and through marketing offices in London, Hong Kong and Singapore.

In addition to these primary strategic initiatives, we have specific strategies within each of our operating segments, which are described in the "Business" section of this prospectus.

The following operating principles support our primary and segment-specific strategies:

- **OPERATE A FULL-SERVICE PLATFORM.** We operate a full-service platform to serve the wide array of our customers' needs by originating sales through our diverse distribution channels, offering a comprehensive portfolio of products and services, administering these products and services efficiently using information technology and managing a significant portion of the assets we accumulate for our customers.
- **BUILD ON STRONG CUSTOMER RELATIONSHIPS.** We are committed to building on our strong customer relationships by providing products and services that respond to their needs and by increasing the global awareness of our brand.
- **FOCUS ON FINANCIAL PERFORMANCE.** We have taken specific actions to improve our operating earnings over the last several years, and we intend to continue to focus each of our businesses to further improve financial performance by:
  - managing capital effectively;
  - improving cost management; and
  - actively managing our investment portfolio.
- **REINFORCE OUR CULTURE.** We are committed to strengthening our organization's performance-oriented culture through a new incentive compensation program, a management evaluation system and a stock option plan, each designed to enhance performance.

#### THE DEMUTUALIZATION

The offering of our shares is made in connection with the conversion of Principal Mutual Holding Company from a mutual insurance holding company into a stock company in a process called a demutualization. Upon demutualization, the membership interests of Principal Life's policyholders in Principal Mutual Holding Company will be extinguished, and eligible policyholders will receive compensation in exchange for the extinguishment of their membership interests. Their compensation will be in the form of our common stock, cash or policy credits, depending upon, among other things, the type of policy or policyholder.

The policyholders entitled to vote on the plan of conversion approved the plan of conversion at a meeting held on July 24, 2001, by approximately 92% of the votes cast. In order for the demutualization to be consummated and for this offering to occur, the plan of conversion must have been approved by the Insurance Commissioner of the State of Iowa

after a public hearing, which was held on July 25, 2001. The Insurance Commissioner of the State of Iowa approved the plan of conversion on August 28, 2001. In addition, the effectiveness of the demutualization and the closing of this offering are conditioned on their simultaneous occurrence.

We are currently a wholly-owned subsidiary of Principal Mutual Holding Company. The demutualization of Principal Mutual Holding Company includes the following steps, all of which will occur on the date of the closing of this offering:

- Principal Mutual Holding Company will convert from a mutual insurance holding company into a stock company;
- all membership interests of Principal Life's policyholders in Principal Mutual Holding Company will be extinguished;
- the converted Principal Mutual Holding Company will merge with and into one of our wholly-owned subsidiaries;
- we will sell shares of our common stock to the public in this offering;
- policyholders entitled to receive compensation in the demutualization will receive shares of our common stock, cash or policy credits as compensation for the extinguishment of their membership interests in Principal Mutual Holding Company no later than 75 days after the closing of this offering, unless the Insurance Commissioner of the State of Iowa approves a later date; and
- we will contribute to Principal Life all or a portion of the net proceeds from this offering, as described in "Use of Proceeds".

In addition to this offering, we may also conduct a private placement of our common stock, a private placement or public offering of convertible preferred stock, a private placement or public offering of debt or seek other sources of capital. The primary purpose of any of these capital raising transactions would be to fund cash and policy credit elections.

When the demutualization and this offering are complete, we will be a public company and will indirectly own 100% of the common stock of Principal Life and other operating subsidiaries of the Principal Financial Group.

EXCHANGE RATE TRANSLATION

We translated foreign-denominated balance sheet data and assets under management, as applicable, at the appropriate end of period exchange rate. We translated foreign-denominated income statement data and asset flow data, as applicable, at the average exchange rate for the appropriate period. BT Financial Group, our largest international subsidiary, primarily operates in Australia. The following end of period exchange rates and average exchange rates for the Australian dollar to U.S. dollar were as follows for the periods indicated:

EXCHANGE RATE  
AUSTRALIAN DOLLAR COMPARED TO U.S. DOLLAR

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,	AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
END OF PERIOD EXCHANGE RATES.....	A\$ 1.0000	A\$ 1.0000	A\$ 1.0000	A\$ 1.0000
	US\$0.5081	US\$0.5556	US\$0.6543	US\$0.6133
AVERAGE EXCHANGE RATES.....	A\$ 1.0000	A\$ 1.0000	A\$ 1.0000	
	US\$0.5139	US\$0.5738	US\$0.6499	

These rates are based on noon rates of exchange provided by a third party financial data source. At October 22, 2001, the noon rate of exchange was A\$1:US\$0.5078.

OUR PRINCIPAL EXECUTIVE OFFICES ARE LOCATED AT 711 HIGH STREET, DES MOINES, IOWA 50392.  
OUR TELEPHONE NUMBER IS (515) 247-5111.

THE OFFERING

Common stock offered.....100.0 million shares

Common stock outstanding  
after the offering.....360.6 million shares

Use of proceeds.....Our net proceeds from the offering will be \$1,753.3 million, or \$2,018.8 million if the underwriters exercise their option to purchase additional shares in full. We will contribute all or a portion of the net proceeds to Principal Life to fund (1) policy credits and cash payments for policyholders for whom policy credits or cash are the required form of compensation; (2) the elections for cash and the elections or deemed elections for ACCOUNT VALUE POLICY CREDITS that are attributable to policyholders entitled to these forms of compensation; and (3) an amount equal to the fees and expenses of the demutualization paid by Principal Life. Under the plan of conversion, we may retain up to \$250.0 million of any remaining proceeds. We must contribute any remaining proceeds, before any exercise of the underwriters' over-allotment option, in excess of this \$250.0 million limit to Principal Life.

Dividend policy.....Subject to our financial condition and declaration by our board of directors, we currently intend to pay regular annual cash dividends on our common stock. We currently intend to declare an annual cash dividend of \$0.25 per share on our common stock. We expect that our first annual cash dividend will be a proportion of that amount, based on the number of months remaining in the calendar year in which we become public. See "Stockholder Dividend Policy".

New York Stock Exchange  
symbol.....PFG

Unless we specifically state otherwise, the information in this prospectus does not take into account the sale of up to 15.0 million additional shares of our common stock, which the underwriters have the option to purchase from us to cover over-allotments.

SUMMARY HISTORICAL FINANCIAL INFORMATION

The following table provides summary historical consolidated financial information of Principal Mutual Holding Company, the predecessor to Principal Financial Group, Inc. prior to the demutualization, and will apply to Principal Financial Group, Inc. following the demutualization. We derived the consolidated financial information for each of the years ended December 31, 2000, 1999 and 1998 and as of December 31, 2000 and 1999 from our audited consolidated financial statements and notes to the financial statements included in this prospectus. We derived the consolidated financial information for the years ended December 31, 1997 and 1996 and as of December 31, 1998, 1997 and 1996 from our audited consolidated financial statements not included in this prospectus. We derived the summary consolidated financial information for the six months ended June 30, 2001 and 2000 and as of June 30, 2001 from our unaudited interim consolidated financial statements included in this prospectus. We derived the summary consolidated financial information as of June 30, 2000 from our unaudited interim consolidated financial statements not included in this prospectus. All unaudited interim consolidated financial information presented in the table below reflects all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of our consolidated financial position and results of operations for such periods. The results of operations for the six months ended June 30, 2001 are not necessarily indicative of the results to be expected for the full year. The following summary consolidated financial information, other than the Principal Life statutory data, has been prepared in accordance with U.S. generally accepted accounting principles, or GAAP.

The following is a summary and, in order to fully understand our consolidated financial information, you should also read "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the notes to the financial statements included in this prospectus. The results for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period.

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,				
	2001(2)	2000(2)	2000(2)	1999(2)	1998(2)	1997(2)	1996(2)
(\$ IN MILLIONS)							
<b>INCOME STATEMENT DATA:(1)</b>							
<b>Revenues:</b>							
Premiums and other considerations.....	\$1,955.3	\$1,992.7	\$3,996.4	\$3,937.6	\$3,818.4	\$4,667.8	\$5,120.9
Fees and other revenues.....	856.3	783.2	1,576.3	1,287.3	978.8	881.9	722.4
Net investment income.....	1,686.0	1,558.1	3,172.3	3,072.0	2,933.9	2,936.6	2,894.0
Net realized capital gains (losses).....	(176.9)	31.5	139.9	404.5	465.8	175.3	387.8
<b>Total revenues.....</b>	<b>4,320.7</b>	<b>4,365.5</b>	<b>8,884.9</b>	<b>8,701.4</b>	<b>8,196.9</b>	<b>8,661.6</b>	<b>9,125.1</b>
<b>Expenses:</b>							
Benefits, claims and settlement expenses...	2,639.2	2,631.1	5,232.3	5,260.9	5,089.0	5,632.5	6,086.5
Dividends to policyholders.....	162.1	155.8	312.7	304.6	298.7	299.3	298.5
Operating expenses.....	1,228.2	1,228.0	2,479.4	2,070.3	2,074.0	2,035.5	1,909.8
<b>Total expenses.....</b>	<b>4,029.5</b>	<b>4,014.9</b>	<b>8,024.4</b>	<b>7,635.8</b>	<b>7,461.7</b>	<b>7,967.3</b>	<b>8,294.8</b>
Income before income taxes and cumulative effect of accounting change.....	291.2	350.6	860.5	1,065.6	735.2	694.3	830.3
Income taxes.....	56.1	105.3	240.3	323.5	42.2	240.8	304.3
Income before cumulative effect of accounting change.....	235.1	245.3	620.2	742.1	693.0	453.5	526.0
Cumulative effect of accounting change, net of related income taxes.....	(10.7)	--	--	--	--	--	--
<b>Net income.....</b>	<b>\$ 224.4</b>	<b>\$ 245.3</b>	<b>\$ 620.2</b>	<b>\$ 742.1</b>	<b>\$ 693.0</b>	<b>\$ 453.5</b>	<b>\$ 526.0</b>

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,				
	2001(2)	2000(2)	2000(2)	1999(2)	1998(2)	1997(2)	1996(2)
	(\$ IN MILLIONS)						
<b>BALANCE SHEET DATA:(1)</b>							
Invested assets.....	\$44,403.2	\$41,224.9	\$42,090.6	\$41,343.2	\$40,686.7	\$39,572.2	\$38,658.3
Separate account assets.....	33,739.5	36,080.6	34,916.2	34,992.3	29,009.3	23,560.1	17,166.3
All other assets.....	7,087.0	7,040.8	7,398.1	7,617.7	4,350.7	4,002.9	3,358.7
Total assets.....	\$85,229.7	\$84,346.3	\$84,404.9	\$83,953.2	\$74,046.7	\$67,135.2	\$59,183.3
<b>Policyholder liabilities.....</b>							
Policyholder liabilities.....	\$39,159.4	\$37,412.4	\$38,243.6	\$37,808.9	\$35,885.1	\$35,306.1	\$34,766.3
Separate account liabilities.....	33,739.5	36,080.6	34,916.2	34,992.3	29,009.3	23,560.1	17,166.3
Short-term debt.....	675.9	390.7	459.5	547.3	290.9	313.7	198.5
Long-term debt.....	1,390.6	1,538.5	1,336.5	1,492.9	670.9	458.9	399.1
All other liabilities.....	3,735.9	3,290.3	3,196.6	3,558.9	2,523.3	2,212.2	1,998.6
Total liabilities.....	\$78,701.3	\$78,712.5	\$78,152.4	\$78,400.3	\$68,379.5	\$61,851.0	\$54,528.8
<b>Retained earnings.....</b>							
Retained earnings.....	\$ 6,536.9	\$ 5,937.6	\$ 6,312.5	\$ 5,692.3	\$ 4,950.2	\$ 4,257.2	\$ 3,803.7
Net unrealized gains (losses) on available-for-sale securities.....	268.6	(178.2)	129.9	(79.1)	745.9	1,037.5	859.7
Net foreign currency translation adjustment.....	(277.1)	(125.6)	(189.9)	(60.3)	(28.9)	(10.5)	(8.9)
Total equity.....	\$ 6,528.4	\$ 5,633.8	\$ 6,252.5	\$ 5,552.9	\$ 5,667.2	\$ 5,284.2	\$ 4,654.5
<b>PRINCIPAL LIFE STATUTORY DATA:(3)</b>							
Premiums and deposits(4).....	\$ 2,301.9	\$ 7,665.5	\$15,653.3	\$15,709.8	\$14,120.3	\$12,710.9	\$12,156.2
Net income(5).....	125.2	355.1	912.6	713.7	511.4	432.2	415.0
<b>Statutory capital and surplus(6).....</b>							
Statutory capital and surplus.....	\$ 3,328.9	\$ 3,095.4	\$ 3,356.4	\$ 3,151.9	\$ 3,031.5	\$ 2,811.1	\$ 2,503.5
Asset valuation reserve.....	878.0	951.2	919.8	953.8	966.9	1,087.9	1,005.0
Statutory capital and surplus and asset valuation reserve.....	\$ 4,206.9	\$ 4,046.6	\$ 4,276.2	\$ 4,105.7	\$ 3,998.4	\$ 3,899.0	\$ 3,508.5
<b>OTHER SUPPLEMENTAL DATA:</b>							
Net income.....	\$ 224.4	\$ 245.3	\$ 620.2	\$ 742.1	\$ 693.0	\$ 453.5	\$ 526.0
Less:							
Net realized capital gains (losses), as adjusted(7).....	(108.2)	23.1	93.1	266.9	320.7	111.4	261.0
Non-recurring items(8).....	(31.4)	(75.8)	(101.0)	--	104.8	--	--
Operating earnings.....	\$ 364.0	\$ 298.0	\$ 628.1	\$ 475.2	\$ 267.5	\$ 342.1	\$ 265.0
Operating return on average equity(9)...	11.1%	8.3%	10.5%	8.9%	5.8%	8.5%	7.5%
Total return on average equity(10).....	9.6%	8.4%	10.3%	13.9%	15.1%	11.3%	14.9%
<b>Operating earnings before amortization of goodwill and other intangibles.....</b>							
Operating earnings before amortization of goodwill and other intangibles.....	\$ 385.6	\$ 317.9	\$ 670.8	\$ 492.0	\$ 304.0	\$ 352.0	\$ 273.7
<b>Assets under management (\$ in billions).....</b>							
Assets under management (\$ in billions).....	\$ 116.9	\$ 117.1	\$ 117.5	\$ 116.6	\$ 80.4	\$ 72.1	\$ 63.0
<b>Number of employees (actual).....</b>							
Number of employees (actual).....	17,646	16,999	17,473	17,129	15,970	17,637	17,010

We evaluate segment performance by segment operating earnings, which excludes the effect of net realized capital gains and losses, as adjusted, and non-recurring events and transactions. We determine segment operating earnings by adjusting GAAP net income for net realized capital gains and losses, as adjusted, and non-recurring items that we believe are not indicative of overall operating trends. While these items may be significant components in understanding and assessing our consolidated financial performance, we believe the presentation of segment operating earnings enhances the understanding of our results of operations by highlighting earnings attributable to the normal, recurring operations of our businesses. However, segment operating earnings are not a substitute for net income determined in accordance with GAAP.



The following table provides selected segment information as of or for the six months ended June 30, 2001 and 2000, and as of or for each of the years ended December 31, 2000, 1999 and 1998. The segment information is reported on a consolidated basis.

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,				AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001(2)		2000(2)		2000(2)		1999(2)
	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL	AMOUNT
(\$ IN MILLIONS)							
<b>OPERATING EARNINGS DATA:</b>							
Operating revenues:							
U.S. Asset Management and Accumulation(11).....	\$ 1,858.2	43%	\$ 1,700.7	39%	\$ 3,533.9	40%	\$ 3,472.6
International Asset Management and Accumulation.....	310.1	7	309.5	7	630.7	7	379.6
Life and Health Insurance.....	1,978.2	46	2,100.7	48	4,122.6	46	3,985.5
Mortgage Banking.....	293.1	7	180.7	4	359.8	4	398.3
Corporate and Other(11)(12).....	57.5	1	40.5	1	97.1	1	61.9
Total operating revenues.....	4,497.1	104	4,332.1	99	8,744.1	98	8,297.9
Net realized capital gains (losses), including recognition of front-end fee revenues(7).....	(176.4)	(4)	33.4	1	140.8	2	403.5
Total consolidated revenues.....	\$ 4,320.7	100%	\$ 4,365.5	100%	\$ 8,884.9	100%	\$ 8,701.4
<b>Operating earnings (loss):</b>							
U.S. Asset Management and Accumulation.....	\$ 176.9	48%	\$ 177.3	59%	\$ 356.6	57%	\$ 356.6
International Asset Management and Accumulation.....	(4.7)	(1)	(3.7)	(1)	(8.5)	(1)	(38.4)
Life and Health Insurance.....	90.9	25	86.0	29	162.3	26	90.7
Mortgage Banking.....	68.8	19	34.4	12	50.0	8	56.8
Corporate and Other.....	32.1	9	4.0	1	67.7	10	9.5
Total operating earnings.....	\$ 364.0	100%	\$ 298.0	100%	\$ 628.1	100%	\$ 475.2
<b>INCOME STATEMENT DATA:</b>							
Net income (loss):							
U.S. Asset Management and Accumulation.....	\$ 125.3	56%	\$ 142.2	58%	\$ 320.7	52%	\$ 321.2
International Asset Management and Accumulation.....	(25.9)	(12)	(0.2)	--	(7.1)	(1)	(30.7)
Life and Health Insurance.....	86.3	38	136.1	55	209.6	34	100.8
Mortgage Banking.....	68.8	31	34.4	14	50.0	8	56.8
Corporate and Other.....	(30.1)	(13)	(67.2)	(27)	47.0	7	294.0
Total net income.....	\$ 224.4	100%	\$ 245.3	100%	\$ 620.2	100%	\$ 742.1
<b>BALANCE SHEET DATA:</b>							
Total assets:							
U.S. Asset Management and Accumulation.....	\$66,182.4	78%	\$65,109.4	77%	\$65,795.9	78%	\$65,096.4
International Asset Management and Accumulation.....	4,919.6	6	5,547.3	7	5,525.9	7	5,926.8
Life and Health Insurance.....	10,637.2	12	10,293.8	12	10,569.0	12	10,070.8
Mortgage Banking.....	2,168.9	3	1,606.3	2	1,556.3	2	1,737.7
Corporate and Other(13).....	1,321.6	1	1,789.5	2	957.8	1	1,121.5
Total assets.....	\$85,229.7	100%	\$84,346.3	100%	\$84,404.9	100%	\$83,953.2
<b>OTHER SUPPLEMENTAL DATA:</b>							
Assets Under Management:							
(\$ in billions)							
U.S. Asset Management and Accumulation.....	\$ 78.7	68%	\$ 73.9	63%	\$ 78.1	67%	\$ 75.6
International Asset Management and Accumulation.....	25.7	22	29.7	26	28.4	24	30.6
Life and Health Insurance.....	9.5	8	9.2	8	9.3	8	8.7
Mortgage Banking(14).....	0.3	--	1.6	1	0.2	--	0.5
Corporate and Other.....	2.7	2	2.7	2	1.5	1	1.2
Total assets under management.....	\$ 116.9	100%	\$ 117.1	100%	\$ 117.5	100%	\$ 116.6

AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
1999(2)	1998(2)	
% OF TOTAL	AMOUNT	% OF TOTAL
(\$ IN MILLIONS)		

**OPERATING EARNINGS DATA:**  
Operating revenues:

U.S. Asset Management and Accumulation(11).....	40%	\$ 2,933.1	36%
International Asset Management and Accumulation.....	4	223.1	3
Life and Health Insurance.....	46	3,893.1	47
Mortgage Banking.....	4	340.6	4
Corporate and Other(11)(12).....	1	342.5	4
	---	---	---
Total operating revenues.....	95	7,732.4	94
Net realized capital gains (losses), including recognition of front-end fee revenues(7).....	5	464.5	6
	---	---	---
Total consolidated revenues.....	100%	\$ 8,196.9	100%
	===	=====	===

Operating earnings (loss):			
U.S. Asset Management and Accumulation.....	75%	\$ 238.4	89%
International Asset Management and Accumulation.....	(8)	(35.4)	(13)
Life and Health Insurance.....	19	50.0	19
Mortgage Banking.....	12	58.8	22
Corporate and Other.....	2	(44.3)	(17)
	---	---	---
Total operating earnings.....	100%	\$ 267.5	100%
	===	=====	===

INCOME STATEMENT DATA:			
Net income (loss):			
U.S. Asset Management and Accumulation.....	43%	\$ 277.0	40%
International Asset Management and Accumulation.....	(4)	(10.1)	(1)
Life and Health Insurance.....	13	112.0	16
Mortgage Banking.....	8	58.8	8
Corporate and Other.....	40	255.3	37
	---	---	---
Total net income.....	100%	\$ 693.0	100%
	===	=====	===

BALANCE SHEET DATA:			
Total assets:			
U.S. Asset Management and Accumulation.....	78%	\$58,701.5	79%
International Asset Management and Accumulation.....	7	1,239.4	2
Life and Health Insurance.....	12	9,219.5	13
Mortgage Banking.....	2	1,810.4	2
Corporate and Other(13).....	1	3,075.9	4
	---	---	---
Total assets.....	100%	\$74,046.7	100%
	===	=====	===

OTHER SUPPLEMENTAL DATA:			
Assets Under Management:			
(\$ in billions)			
U.S. Asset Management and Accumulation.....	65%	\$ 67.2	84%
International Asset Management and Accumulation.....	26	1.2	1
Life and Health Insurance.....	8	8.2	10
Mortgage Banking(14).....	--	0.7	1
Corporate and Other.....	1	3.1	4
	---	---	---
Total assets under management.....	100%	\$ 80.4	100%
	===	=====	===

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(1) We have reclassified periods prior to June 30, 2001, to conform to the presentation for that period.

(2) Our consolidated financial results were affected by the following transactions that affect year-to-year comparability:

- On September 25, 2001, we disposed of all the stock of PT Asuransi Jiwa Principal Indonesia, our subsidiary in Indonesia. We currently have no business operations in Indonesia. Total assets of our operations in Indonesia as of June 30, 2001 were \$3.4 million. We included nominal revenues and net loss from our operations in Indonesia in our consolidated results of operations for the six months ended June 30, 2001 and 2000, and for the years ended December 31, 2000, 1999 and 1998.
- On February 15, 2001, we disposed of all of the stock of Principal International Espana, S.A. de Seguros de Vida, our subsidiary in Spain, for nominal proceeds, resulting in a net realized capital loss of \$38.4 million, ceasing our business operations in Spain. Total assets of our operations in Spain as of December 31, 2000 were \$222.7 million. We included revenues of \$33.1 million from our operations in Spain in our consolidated results of operations for the six months ended June 30, 2000, and revenues of \$49.4 million, \$51.7 million and \$46.0 million in our results of operations for the years ended December 31, 2000, 1999 and 1998, respectively. We included net income of \$2.2 million from our operations in Spain for the six months ended June 30, 2000, and a net loss of \$1.2 million and net income of \$0.9 million and \$2.8 million in our results of operations for the years ended December 31, 2000, 1999 and 1998, respectively. We did not include revenues or net income from our operations in Spain in our consolidated results of operations for the six months ended June 30, 2001.
- On August 31, 1999, we acquired several companies affiliated with Bankers Trust Australia Group from Deutsche Bank AG at a purchase price of \$1.4 billion. The acquired companies now operate under the name BT Financial Group. We accounted for the acquisition using the purchase method. We included the results of operations of the acquired companies in our International Asset Management and Accumulation segment and our consolidated financial statements from the date of acquisition. We included revenues of \$122.5 million and net loss of \$5.8 million in our consolidated results of operations for the six months ended June 30, 2001. We included revenues of \$145.4 million and net income of \$6.2 million in our consolidated results of operations for the six months ended June 30, 2000. We included revenues of \$285.5 million and net income of \$6.5 million in our consolidated results of operations for the year ended December 31, 2000. We included revenues of \$116.5 million and net loss of \$3.1 million in our consolidated results of operations for the year ended December 31, 1999. We accounted for the purchase price as follows: \$897.4 million of identifiable intangibles, consisting primarily of management rights and the BT brand name, \$38.5 million of workforce intangibles and \$408.6 million of resulting goodwill, which are being amortized on a straight line basis over 40 years, 8 years and 25 years, respectively.
- We acquired Compania de Seguros de Vida El Roble S.A., or El Roble, a Chilean life insurance company, for a purchase price of \$73.4 million in July 1998. We included El Roble's financial results in our International Asset Management and Accumulation segment. We combined the operations of our existing Chilean life insurance affiliate with the operations of El Roble to form Principal International de Chile. Our consolidated financial results related to these companies' combined operations include: total revenues of \$108.6 million and \$95.7 million for the six months ended June 30, 2001 and 2000, respectively, and \$200.2 million, \$178.1 million and \$155.2 million for the years ended December 31, 2000, 1999 and 1998, respectively; and net income of \$4.3 million and \$3.4 million for the six months ended June 30, 2001 and 2000, respectively, and \$10.2 million, \$0.5 million and \$17.0 million for the years ended December 31, 2000, 1999 and 1998, respectively.
- In July 1998, we established our residential mortgage loan wholesale distribution system, a new distribution channel, by acquiring ReliaStar Mortgage Corporation for a purchase price of \$18.6 million. We have integrated the operations of ReliaStar Mortgage Corporation into Principal Residential Mortgage, Inc., as part of our Mortgage Banking segment.
- Effective April 1, 1998, we transferred substantially all of our health maintenance organization operations, or HMO operations, to Coventry Health Care, Inc., or Coventry, in exchange for 42% of their common stock. Our net equity in the transferred HMO operations had a carrying value of \$170.0 million on April 1, 1998. We sold our remaining HMO operations in 1998 for \$20.5 million resulting in no realized capital gain or loss. Prior to the transfer to Coventry, our Corporate and Other segment included \$266.7 million of HMO revenues in our results for 1998. We report our investment in Coventry in our Corporate and Other segment and account for it using the equity method. Our share of Coventry's net income was \$9.7 million and \$10.8 million for the six months ended June 30, 2001 and 2000, respectively, and \$20.0 million and \$19.1 million for the years ended December 31, 2000 and 1999, respectively. Our share of Coventry's net loss was \$9.8 million for the year ended December 31, 1998. In September 2000, we sold a portion of our Coventry stock, which reduced our ownership interest to approximately 25% of Coventry stock and resulted in a net realized capital gain of \$13.9 million, net of tax. Our carrying amount in Coventry was \$134.6 million as of June 30, 2001.

(3) We have provided statutory data from quarterly and annual statements of Principal Life filed with insurance regulatory authorities. Certain financial information for periods beginning on or after January 1, 2001 is

not comparable to information from earlier periods. We prepared statutory data as of or for the six months ended June 30, 2001 in conformity with the NAIC Codification of Statutory Principles ("Codification"), adopted as

prescribed and permitted by the Insurance Division, Department of Commerce of the State of Iowa, effective January 1, 2001. As allowed by Codification, we did not restate prior period information. We prepared statutory data as of or for the six months ended June 30, 2000 and the years ended December 31, 2000, 1999, 1998, 1997 and 1996 in conformity with accounting practices prescribed or permitted on the dates thereof by the Insurance Division, Department of Commerce of the State of Iowa.

- (4) Codification, as adopted by Principal Life on January 1, 2001, has significantly impacted the reporting of Principal Life's statutory premiums and deposits for the six months ended June 30, 2001. Under Codification, we no longer report amounts received for deposit-type contracts in the statement of operations as revenue, but rather report these amounts directly as an increase in an appropriate policy reserve account, a treatment that is similar to that under U.S. GAAP. This has the effect of decreasing reported total revenues and total expenses of Principal Life, with no effect to statutory net income or statutory surplus. Premiums and deposits for the six months ended June 30, 2000, and for the years ended December 31, 2000, 1999, 1998, 1997 and 1996 included amounts received for deposit-type contracts of \$5,432.8 million, \$11,273.2 million, \$11,571.5 million, \$10,312.6 million, \$8,694.9 million and \$7,493.9 million, respectively.
- (5) Codification, as adopted by Principal Life on January 1, 2001, has impacted the reporting of Principal Life's statutory net income for the six months ended June 30, 2001. Under Codification our net income has been significantly impacted due to a change in the accounting for undistributed income (loss) from subsidiaries. We no longer report undistributed income (loss) from subsidiaries as part of net investment income, but rather report these amounts as unrealized gains and losses, which are excluded from the calculation of net income. This has the effect of decreasing reported total statutory revenues and net income, but has no effect on statutory surplus. Undistributed income from subsidiaries for the six months ended June 30, 2000, and for the years ended December 31, 2000 and 1999 were \$100.0 million, \$208.9 million and \$159.9 million, respectively, and undistributed loss from subsidiaries for the years ended December 31, 1998, 1997 and 1996 were \$0.4 million, \$41.3 million and \$104.1 million, respectively.
- (6) On August 24, 2001, Principal Life paid a statutory dividend of \$250.0 million, which reduced its surplus by that amount.
- (7) Net realized capital gains (losses), as adjusted, are net of tax, related changes in the amortization pattern of deferred policy acquisition costs, recognition of front-end fee revenues for sales charges on pension products and services and net realized capital gains credited to customers. This presentation may not be comparable to presentations made by other companies. Deferred policy acquisition costs represent commissions and other selling expenses that vary with and are directly related to the production of business. These acquisition costs are deferred and amortized in conformity with GAAP.

Following is a reconciliation of net realized capital gains (losses) from the consolidated financial statements and the adjustment made to calculate segment operating earnings for the periods indicated:

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,				
	2001	2000	2000	1999	1998	1997	1996
	(\$ IN MILLIONS)						
Net realized capital gains (losses).....	\$ (176.9)	\$ 31.5	\$ 139.9	\$ 404.5	\$ 465.8	\$ 175.3	\$ 387.8
Recognition of front-end fee revenues...	0.5	1.9	0.9	(1.0)	(1.3)	(0.9)	--
Net realized capital gains (losses), including recognition of front-end fee revenues.....	(176.4)	33.4	140.8	403.5	464.5	174.4	387.8
Amortization of deferred policy acquisition costs related to net realized capital gains (losses).....	3.9	(3.4)	(0.3)	4.4	5.7	(1.7)	--
Amounts credited to contractholder accounts.....	--	--	--	--	(26.3)	--	--
Non-recurring net realized capital losses.....	--	--	--	--	(1.7)	--	--
Net realized capital gains (losses), including recognition of front-end fee revenues, net of related amortization of deferred policy acquisition costs and amounts credited to contractholders.....	(172.5)	30.0	140.5	407.9	442.2	172.7	387.8
Income tax effect.....	64.3	(6.9)	(47.4)	(141.0)	(121.5)	(61.3)	(126.8)
Net realized capital gains (losses), as adjusted.....	\$ (108.2)	\$ 23.1	\$ 93.1	\$ 266.9	\$ 320.7	\$ 111.4	\$ 261.0

- (8) For the six months ended June 30, 2001, we excluded \$31.4 million of non-recurring items, net of tax, from net income for the presentation of operating earnings. The non-recurring items included the negative effects of: (a) expenses related to our demutualization (\$14.8 million); (b) a cumulative effect of change in accounting principle related to our implementation of SFAS 133 (\$10.7 million), as discussed in Note 2 to Principal Mutual Holding Company's unaudited consolidated financial statements; and (c) a loss contingency reserve established for sales practices litigation (\$5.9 million).

For the six months ended June 30, 2000, we excluded \$75.8 million of non-recurring items, net of tax, from net income for our presentation of consolidated operating earnings. The non-recurring items included the negative effects of: (a) a loss contingency reserve established for sales practices litigation (\$75.0 million), and (b) expenses related to our demutualization (\$0.8 million).

For the year ended December 31, 2000, we excluded \$101.0 million of non-recurring items, net of tax, from net income for our presentation of operating earnings. The non-recurring items included the negative effects of (a) a loss contingency reserve established for sales practices litigation (\$93.8 million) and (b) expenses related to our demutualization (\$7.2 million).

For the year ended December 31, 1998, we excluded \$104.8 million of non-recurring items, net of tax, from net income for our presentation of operating earnings. The non-recurring items included:

- the positive effects of (a) Principal Life's release of tax reserves and related accrued interest (\$164.4 million) and (b) accounting changes by our international operations (\$13.3 million); and
- the negative effects of (a) expenses and adjustments for changes in amortization assumptions for deferred policy acquisition costs related to our corporate structure change to a mutual insurance holding company (\$27.4 million) and (b) a contribution related to permanent endowment of the Principal Financial Group Foundation (\$45.5 million).

- (9) We define operating return on average equity as operating earnings divided by average total equity, excluding accumulated other comprehensive income. We calculate the returns for interim reporting periods by using operating earnings for the trailing twelve months. We have excluded accumulated other comprehensive income due to its volatility between periods and because such data are often excluded when evaluating the overall financial performance of insurers. Operating return on average equity should not be considered a substitute for any GAAP measure of performance.
- (10) We define total return on average equity as net income divided by average total equity, excluding accumulated other comprehensive income. We calculate the returns for interim reporting periods by using net income for the trailing twelve months. We have excluded accumulated other comprehensive income due to its volatility between periods and because such data are often excluded when evaluating the overall financial performance of insurers.
- (11) We transferred our U.S. investment management operations from our Corporate and Other segment to our U.S. Asset Management and Accumulation segment effective January 1, 1999. The U.S. Asset Management and Accumulation segment received fee revenues for performing investment management services for other segments in 2001, 2000 and 1999. The Corporate and Other segment received fee revenues for performing investment management services for other segments prior to 1999.
- (12) Includes inter-segment eliminations primarily related to real estate joint venture rental income. We reported rental income from real estate joint ventures for office space used by other segments in the Corporate and Other segment.
- (13) Includes inter-segment elimination amounts related to internally generated mortgage loans and an internal line of credit. The U.S. Asset Management and Accumulation segment and Life and Health Insurance segment reported mortgage loan assets issued for real estate joint ventures. These mortgage loans were reported as liabilities in the Corporate and Other segment. In addition, the Corporate and Other segment managed a revolving line of credit used by other segments.
- (14) Excludes our mortgage loan servicing portfolio.

## RISK FACTORS

An investment in our common stock involves a number of risks. You should consider carefully, in addition to the other information contained in this prospectus, the following factors before investing in shares of our common stock. In reviewing information contained in this prospectus, you should bear in mind that past experience is no indication of future performance.

COMPETITION FROM COMPANIES THAT MAY HAVE GREATER FINANCIAL RESOURCES, BROADER ARRAYS OF PRODUCTS, HIGHER RATINGS AND STRONGER FINANCIAL PERFORMANCE MAY IMPAIR OUR ABILITY TO RETAIN EXISTING CUSTOMERS, ATTRACT NEW CUSTOMERS AND MAINTAIN OUR PROFITABILITY.

We believe that our ability to compete is based on a number of factors including scale, service, product features, price, investment performance, commission structure, distribution capabilities, financial strength ratings and name recognition. We compete with a large number of financial services companies such as banks, broker-dealers, insurers and asset managers, many of which have advantages over us in one or more of the above competitive factors.

Each of our segments faces strong competition. The primary competitors for our U.S. Asset Management and Accumulation segment are asset managers, banks, broker-dealers and insurers. Our ability to increase and retain assets under management is directly related to the performance of our investments as measured against market averages and the performance of our competitors. Even when securities prices are generally rising, performance can be affected by investment styles. For example, as growth stocks have outperformed value stocks for several years ending in 1999, we were at a competitive disadvantage due to our historical emphasis on the value style of investing. Principal Capital Management may also be at a disadvantage in competing for investment management personnel due to its location in Des Moines.

Competition for our International Asset Management and Accumulation segment comes primarily from local financial services firms and other international companies operating on a stand-alone basis or in partnership with local firms. Our Life and Health Insurance segment competes with insurers and health maintenance organizations. We compete with other mortgage bankers, commercial banks, savings and loan associations, credit unions and other insurers in our Mortgage Banking segment.

National banks, with their large existing customer bases, may increasingly compete with insurers as a result of court rulings allowing national banks to sell annuity products in some circumstances, and as a result of recently enacted legislation removing restrictions on bank affiliations with insurers. Specifically, the Gramm-Leach-Bliley Act of 1999 permits mergers that combine commercial banks, insurers and securities firms under one holding company. These developments may increase competition, in particular for our asset management and accumulation businesses, by substantially increasing the number, size and financial strength of potential competitors who may be able to offer, due to economies of scale, more competitive pricing than we can.

A DECLINE OR INCREASED VOLATILITY IN THE SECURITIES MARKETS COULD RESULT IN INVESTORS WITHDRAWING FROM THE MARKETS OR DECREASING THEIR RATES OF INVESTMENT, EITHER OF WHICH COULD REDUCE OUR NET INCOME, REVENUES AND ASSETS UNDER MANAGEMENT.

Favorable performance by the U.S., European and Australian securities markets for several years ending in 1999 substantially increased investments in these markets and benefited our asset management and accumulation businesses and increased our assets under management. In contrast to the U.S., European and Australian securities markets, the securities markets in the emerging economies in which we operate or invest, such as India or Argentina, have experienced economic disruption, devaluations of their currencies or negative growth rates during this period, which suppressed our revenues and profits. In addition, because the revenues of our asset management businesses are, to a large extent, based on the value of assets under management, a decline in the value of these assets decreases our revenues. Further declines or turmoil in the U.S., European and Australian securities markets could lead investors to withdraw from these markets, decrease their rates of investment or refrain from making new investments which may reduce our net income, revenues and assets under management. Our assets, earnings and ability to generate new sales in recent years have also increased due to significant growth in the retirement-oriented investment market. Some of that growth is attributable to the expansion of government mandated retirement savings programs outside the United States. If these programs are reduced or eliminated, our net income, revenues and assets would suffer.

A DOWNGRADE IN PRINCIPAL LIFE'S FINANCIAL STRENGTH RATINGS MAY INCREASE POLICY SURRENDERS AND WITHDRAWALS, REDUCE NEW SALES AND TERMINATE RELATIONSHIPS WITH DISTRIBUTORS.

Financial strength ratings are important factors in establishing the competitive position of insurance companies. A rating downgrade, or the potential for such a downgrade, of Principal Life could, among other things:

- materially increase the number of policy or contract surrenders for all or a portion of their net cash values and withdrawals by policyholders of cash values from their policies;

- result in the termination of our relationships with broker-dealers, banks, agents, wholesalers and other distributors of our products and services; and
- reduce new sales, particularly with respect to general account guaranteed investment contracts and funding agreements purchased by pension plans and other institutions.

See "Business -- Ratings".

**OUR EFFORTS TO REDUCE THE IMPACT OF INTEREST RATE CHANGES ON OUR PROFITABILITY AND SURPLUS MAY NOT BE EFFECTIVE.**

We attempt to significantly reduce the impact of changes in interest rates on the profitability and surplus of our asset accumulation and life and health insurance operations. We accomplish this reduction primarily by managing the duration of our assets relative to the duration of our liabilities. During a period of rising interest rates, policy surrenders, withdrawals and requests for policy loans may increase as customers seek to achieve higher returns. Despite our efforts to reduce the impact of rising interest rates, we may be required to sell assets to raise the cash necessary to respond to such surrenders, withdrawals and loans, thereby realizing capital losses on the assets sold. An increase in policy surrenders and withdrawals may also require us to accelerate amortization of policy acquisition costs relating to these contracts, which would further reduce our net income.

During periods of declining interest rates, borrowers may prepay or redeem mortgages and bonds that we own, which would force us to reinvest the proceeds at lower interest rates. For some of our products, such as guaranteed investment contracts and funding agreements, we are unable to lower the rate we credit to customers in response to the lower return we will earn on our investments. In addition, it may be more difficult for us to maintain our desired spread between the investment income we earn and the interest we credit to our customers during periods of declining interest rates thereby reducing our profitability.

Changes in interest rates can also significantly affect the profitability of our Mortgage Banking segment. During periods of declining interest rates, we may lose mortgage loan servicing fees due to an increase in mortgage loan refinancing activity. During periods of rising interest rates, we may suffer a loss of mortgage loan origination fees due to a decrease in the overall number of home sales and the number of mortgage loan refinancings. For further discussion on interest rate risk management, see "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Quantitative and Qualitative Information About Market Risk -- Interest Rate Risk".

**IF WE ARE UNABLE TO ATTRACT AND RETAIN SALES REPRESENTATIVES AND DEVELOP NEW DISTRIBUTION SOURCES, SALES OF OUR PRODUCTS AND SERVICES MAY BE REDUCED.**

We distribute our asset accumulation, asset management and life and health insurance products and services through a variety of distribution channels, including our own internal sales representatives, independent brokers, banks, broker-dealers and other third-party marketing organizations. We must attract and retain sales representatives to sell our products. Strong competition exists among financial services companies for efficient sales representatives. We compete with other financial services companies for sales representatives primarily on the basis of our financial position, support services and compensation and product features. If we are unable to attract and retain sufficient sales representatives to sell our products, our ability to compete and revenues from new sales would suffer.

For example, Rogers Benefit Group, a national independent marketing and service organization, distributes a significant portion of our group insurance products. For the period ended June 30, 2001, Rogers Benefit Group accounted for 37% of our group insurance sales. An interruption in or changes to our relationship with Rogers Benefit Group could impair our ability to market our group insurance products and reduce our revenues accordingly.

**OUR INTERNATIONAL BUSINESSES FACE POLITICAL, LEGAL, OPERATIONAL AND OTHER RISKS THAT COULD REDUCE OUR PROFITABILITY IN THOSE BUSINESSES.**

Our international businesses are subject to comprehensive regulation and supervision from central and/or local governmental authorities in each country in which we operate. New interpretations of existing laws and regulations or the adoption of new laws and regulations may harm our international businesses and reduce our profitability in those businesses. In particular, BT Financial Group's profit could suffer if the Australian superannuation system is repealed or amended to a lower rate of contribution.

Our international businesses face political, legal, operational and other risks that we do not face in our operations in the U.S. We face the risk of discriminatory regulation, nationalization or expropriation of assets, price controls and exchange controls or other restrictions that prevent us from transferring funds from these operations out of the countries in which they operate or converting local currencies we hold into U.S. dollars or other currencies. Some of our international businesses are, and are likely to continue to be, in emerging or recently volatile markets such as India and Argentina where these risks are heightened. In addition, we rely on local staff, including local sales forces, in these countries and we may encounter labor problems especially in countries such as Mexico, Argentina and Brazil where



workers' associations and trade unions are strong. If our business model is not successful in a particular country, we may lose all or most of our investment in that country.

#### FLUCTUATIONS IN FOREIGN CURRENCY EXCHANGE RATES COULD REDUCE OUR PROFITABILITY.

Principal International generally writes policies denominated in various local currencies and invests the premiums and deposits in local currencies. Although investing in local currencies limits the effect of currency exchange rate fluctuation on local operating results, fluctuations in such rates affect the translation of these results into our consolidated financial statements. BT Financial Group conducts its asset management operations in both local currencies and U.S. dollars. Accordingly, fluctuations in foreign currency exchange rates may reduce our profitability. For example, fluctuations in average foreign currency of our international operations to U.S. dollar exchange rates reduced our consolidated operating earnings by \$0.8 million for the six months ended June 30, 2001, by \$0.6 million for the year ended December 31, 2000, and by \$0.3 million for the year ended December 31, 1999. From December 31, 1999 to June 30, 2001, the Australian dollar declined 22% in value relative to the U.S. dollar.

#### A DECLINE IN AUSTRALIAN EQUITY VALUES MAY REDUCE THE PROFITABILITY OF BT FINANCIAL GROUP'S MARGIN LENDING BUSINESS.

A decline in the Australian equity markets or short-term volatility in the Australian securities markets could result in investors withdrawing from the markets or decreasing their rates of investment and level of participation in the margin lending business, either of which could reduce the profitability of BT Financial Group's margin lending business. Additionally, short-term volatility in the securities markets could result in the placing of margin calls. An inability by borrowers under BT Financial Group's margin lending business to satisfy these margin calls may decrease our profits. As of June 30, 2001, the margin lending portfolio balance was \$0.6 billion (A\$1.1 billion).

#### OUR RESERVES ESTABLISHED FOR FUTURE POLICY BENEFITS AND CLAIMS MAY PROVE INADEQUATE, REQUIRING US TO INCREASE LIABILITIES.

Our earnings depend significantly upon the extent to which our actual claims experience is consistent with the assumptions used in setting prices for our products and establishing liabilities for future insurance and annuity policy benefits and claims. The liability that we have established for future policy benefits is based on assumptions concerning a number of factors, including the amount of premiums that we will receive in the future, rate of return on assets we purchase with premiums received, expected claims, expenses and persistency, which is the measurement of the percentage of insurance policies remaining in force from year to year, as measured by premiums. However, due to the nature of the underlying risks and the high degree of uncertainty associated with the determination of the liabilities for unpaid policy benefits and claims, we cannot determine precisely the amounts which we will ultimately pay to settle these liabilities. As a result, we may experience volatility in the level of our reserves from period to period, particularly for our health and disability insurance products. To the extent that actual claims experience is less favorable than our underlying assumptions, we could be required to increase our liabilities, which may harm our financial strength and reduce our profitability.

#### OUR INVESTMENT PORTFOLIO IS SUBJECT TO SEVERAL RISKS WHICH MAY DIMINISH THE VALUE OF OUR INVESTED ASSETS AND AFFECT OUR SALES, PROFITABILITY AND THE INVESTMENT RETURNS CREDITED TO OUR CUSTOMERS.

#### AN INCREASE IN DEFAULTS ON OUR FIXED MATURITY SECURITIES PORTFOLIO MAY REDUCE OUR PROFITABILITY.

We are subject to the risk that the issuers of the fixed maturity securities we own will default on principal and interest payments, particularly if a major downturn in economic activity occurs. As of June 30, 2001, our U.S. investment operations held \$28.5 billion of fixed maturity securities, or 66% of total U.S. invested assets, of which approximately 8% were below investment grade, including \$345.9 million, or 1% of our total fixed maturity securities which we classified as either "problem," "potential problem," or "restructured." See "Investments -- U.S. Investment Operations -- U.S. Investment Results -- Fixed Maturity Securities." As of June 30, 2001, our international investment operations held \$0.8 billion of fixed maturity securities, or 71% of total international invested assets. Some of these securities have been rated on the basis of the issuer's country credit rating while others have not been rated by external agencies, which makes the assessment of credit quality more difficult. See "Investments -- International Investment Operations." An increase in defaults on our fixed maturity securities portfolio could harm our financial strength and reduce our profitability.

#### AN INCREASED RATE OF DELINQUENCY AND DEFAULTS ON OUR COMMERCIAL MORTGAGE LOANS, ESPECIALLY THOSE WITH BALLOON PAYMENTS, COULD DECREASE OUR PROFITABILITY.

Our commercial mortgage loan portfolio faces both delinquency and default risk. Commercial mortgage loans of \$10.3 billion represented 23% of our total invested assets as of June 30, 2001. As of June 30, 2001, loans that were either delinquent or in the process of foreclosure totaled, on a statutory basis, \$1.8 million, or less than one-tenth of one percent of our commercial mortgage loan portfolio, compared to the industry average of 0.2% as reported by the American Council of Life Insurers as of June 30, 2001. The performance of our commercial mortgage loan portfolio,

however, may fluctuate in the future. An increase in the delinquency rate of our commercial mortgage loan portfolio could harm our financial strength and decrease our profitability.

As of June 30, 2001, approximately \$7.9 billion, or 75%, of our commercial mortgage loans before valuation allowance had balloon payment maturities. A balloon maturity is a loan with larger dollar amounts of payments becoming due in the later years of the loan. The default rate on commercial mortgage loans with balloon payment maturities has historically been higher than for commercial mortgage loans with standard repayment schedules. Since most of the principal is being repaid at maturity, the amount of loss on a default is generally greater than on other commercial mortgage loans. An increase in defaults on such loans as a result of the foregoing factors could harm our financial strength and reduce our net income.

WE MAY HAVE DIFFICULTY SELLING OUR PRIVATELY PLACED FIXED MATURITY SECURITIES, COMMERCIAL MORTGAGE LOANS AND REAL ESTATE INVESTMENTS BECAUSE THEY ARE LESS LIQUID THAN OUR PUBLICLY TRADED FIXED MATURITY SECURITIES.

As of June 30, 2001, our privately placed fixed maturity securities, commercial mortgage loans and real estate investments represented approximately 52% of the value of our invested assets. If we require significant amounts of cash on short notice, we may have difficulty selling these investments at attractive prices, in a timely manner, or both.

DERIVATIVE INSTRUMENTS MAY NOT BE HONORED BY COUNTERPARTIES RESULTING IN INEFFECTIVE HEDGING OF OUR RISKS.

We use derivative instruments to hedge various risks we face in our businesses. We enter into a variety of derivative instruments, including interest rate swaps, swaptions, currency swaps, financial futures and mortgage-backed security forward contracts, with a number of counterparties. If, however, our counterparties fail to honor their obligations under the derivative instruments, we will have failed to effectively hedge the related risk. That failure may harm our financial strength and reduce our profitability.

ENVIRONMENTAL LIABILITY EXPOSURE MAY RESULT FROM OUR COMMERCIAL MORTGAGE LOAN PORTFOLIO AND REAL ESTATE INVESTMENTS.

Liability under environmental protection laws resulting from our commercial mortgage loan portfolio and real estate investments may harm our financial strength and reduce our profitability. Under the laws of several states, contamination of a property may give rise to a lien on the property to secure recovery of the costs of cleanup. In some states, this kind of lien has priority over the lien of an existing mortgage against the property, which would impair our ability to foreclose on that property should the related loan be in default. In addition, under the laws of some states and under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980, we may be liable for costs of addressing releases or threatened releases of hazardous substances that require remedy at a property securing a mortgage loan held by us, if our agents or employees have become sufficiently involved in the hazardous waste aspects of the operations of the related obligor on that loan, regardless of whether or not the environmental damage or threat was caused by the obligor. We also may face this liability after foreclosing on a property securing a mortgage loan held by us. This may harm our financial strength and decrease our profitability.

REGIONAL CONCENTRATION OF OUR COMMERCIAL MORTGAGE LOAN PORTFOLIO IN CALIFORNIA MAY SUBJECT US TO ECONOMIC DOWNTURNS OR LOSSES ATTRIBUTABLE TO EARTHQUAKES IN THAT STATE.

California accounted for 22%, or \$2.3 billion, of our commercial mortgage loan portfolio as of June 30, 2001. Due to this concentration of commercial mortgage loans in California, we are exposed to potential losses resulting from the risk of an economic downturn in California as well as to catastrophes, such as earthquakes, that may affect the region. While we generally do not require earthquake insurance for properties on which we make commercial mortgage loans, we do take into account property specific engineering reports, construction type and geographical concentration by fault lines in our investment underwriting guidelines. If economic conditions in California deteriorate or catastrophes occur, we may experience delinquencies on the portion of our commercial mortgage loan portfolio located in California in the future, which may harm our financial strength and reduce our profitability.

OUR ABILITY TO PAY DIVIDENDS AND MEET OUR OBLIGATIONS MAY BE CONSTRAINED BY THE LIMITATIONS ON DIVIDENDS IOWA INSURANCE LAWS IMPOSE ON PRINCIPAL LIFE.

We are an insurance holding company whose assets include all of the outstanding shares of the common stock of Principal Life and other direct subsidiaries. Our ability to pay dividends to our stockholders and meet our obligations, including paying operating expenses and any debt service, depends upon the receipt of dividends from Principal Life. Iowa insurance laws impose limitations on the ability of Principal Life to pay dividends to us. Any inability of Principal Life to pay dividends to us in the future may cause us to be unable to pay dividends to our stockholders and meet our other obligations.

WE MAY NEED TO FUND DEFICIENCIES IN OUR CLOSED BLOCK; ASSETS ALLOCATED TO THE CLOSED BLOCK BENEFIT ONLY THE HOLDERS OF CLOSED BLOCK POLICIES.

In connection with its conversion in 1998 into a stock life insurance company, Principal Life established an accounting mechanism, known as a CLOSED BLOCK, for the benefit of participating ordinary life insurance policies that had a dividend scale in force on July 1, 1998. Dividend scales are the actuarial formulas used by life insurance companies to determine amounts payable as dividends on participating policies based on experience factors relating to, among other things, investment results, mortality, lapse rates, expenses, premium taxes and policy loan interest and utilization rates. The Closed Block was designed to provide reasonable assurance to policyholders included in the Closed Block that, after the conversion, assets would be available to maintain the aggregate dividend scales in effect for 1997 if the experience underlying such scales were to continue.

We allocated assets to the Closed Block as of July 1, 1998 in an amount such that we expect their cash flows, together with anticipated revenues from the policies in the Closed Block, to be sufficient to support the Closed Block business, including payment of claims, expenses, charges and taxes and to provide for the continuation of aggregate dividend scales in accordance with the 1997 policy dividend scales if the experience underlying such scales continues, and to allow for appropriate adjustments in such scales if the experience changes. We bear the costs of expenses associated with Closed Block policies and, accordingly, these costs were not funded as part of the assets allocated to the Closed Block. Any increase in such costs in the future will be borne by us. As of June 30, 2001, Closed Block assets and liabilities were \$4,613.4 million and \$5,635.8 million, respectively. As of December 31, 2000, Closed Block assets and liabilities were \$4,526.4 million and \$5,566.8 million, respectively. As of December 31, 1999, Closed Block assets and liabilities were \$4,338.3 million and \$5,415.5 million, respectively.

We will continue to pay guaranteed benefits under the policies included in the Closed Block, in accordance with their terms. The Closed Block assets, cash flows generated by the Closed Block assets and anticipated revenues from policies included in the Closed Block may not be sufficient to provide for the benefits guaranteed under these policies. If they are not sufficient, we must fund the shortfall. Even if they are sufficient, we may choose for business reasons to support dividend payments on policies in the Closed Block with our general account funds.

The Closed Block assets, cash flows generated by the Closed Block assets and anticipated revenues from policies in the Closed Block will benefit only the holders of those policies. In addition, to the extent that these amounts are greater than the amounts estimated at the time we funded the Closed Block, dividends payable in respect of the policies included in the Closed Block may be greater than they would have been in the absence of a Closed Block. Any excess earnings will be available for distribution over time to Closed Block policyholders but will not be available to our stockholders.

CHANGES IN REGULATIONS OR ACCOUNTING STANDARDS MAY REDUCE OUR PROFITABILITY.

CHANGES IN REGULATION IN THE UNITED STATES MAY REDUCE OUR PROFITABILITY.

Our insurance business is subject to comprehensive state regulation and supervision throughout the U.S. The primary purpose of state regulation of the insurance business is to protect policyholders, not stockholders. The laws of the various states establish insurance departments with broad powers to regulate such matters as:

- licensing companies to transact business,
- licensing agents,
- admitting statutory assets,
- mandating a number of insurance benefits,
- regulating premium rates,
- approving policy forms,
- regulating unfair trade and claims practices,
- establishing statutory reserve requirements and solvency standards,
- fixing maximum interest rates on life insurance policy loans and minimum rates for accumulation of surrender values,
- restricting various transactions between affiliates, and
- regulating the types, amounts and valuation of investments.

State insurance regulators and the National Association of Insurance Commissioners, or NAIC, continually reexamine existing laws and regulations, and may impose changes in the future.

Federal legislation and administrative policies in areas such as employee benefit plan regulation, financial services regulation and federal taxation can reduce our profitability. For example, Congress has, from time to time, considered legislation relating to changes in the Employee Retirement Income Security Act of 1974 to permit application of state law remedies, such as consequential and punitive damages, in lawsuits for wrongful denial of benefits, which, if adopted, could increase our liability for damages in future litigation. Additionally, new interpretations of existing laws and the passage of new legislation may harm our ability to sell new policies and increase our claims exposure on policies we issued previously. In addition, reductions in contribution levels to defined contribution plans may decrease our profitability. See "Regulation -- U.S. Operations -- Federal Insurance Initiatives".

#### CHANGES IN FEDERAL TAXATION COULD REDUCE SALES OF OUR INSURANCE, ANNUITY AND INVESTMENT PRODUCTS.

Current federal income tax laws generally permit the tax-deferred accumulation of earnings on the premiums paid by the holders of annuities and life insurance products. Taxes, if any, are payable on income attributable to a distribution under the contract for the year in which the distribution is made. Congress has, from time to time, considered legislation that would reduce or eliminate the benefit of such deferral of taxation on the accretion of value within life insurance and non-qualified annuity contracts. Enactment of this legislation, including a simplified "flat tax" income structure with an exemption from taxation for investment income, could result in fewer sales of our insurance, annuity and investment products.

#### REPEAL OR MODIFICATION OF THE FEDERAL ESTATE TAX COULD REDUCE OUR REVENUES.

The Economic Growth and Tax Relief Reconciliation Act of 2001 amended the federal estate tax laws by increasing the amount of the unified credit beginning in 2002, thereby increasing the amount of property not subject to the estate tax. The Act also gradually reduces the federal estate tax rate over a period of years beginning in 2002, and repeals the tax entirely in 2010. The law in effect prior to the Act, however, is reinstated for years after 2010. Through the six months ended June 30, 2001, we received recurring premium of \$26.1 million for survivorship life insurance policies we have sold. A significant number of these policies were purchased for the purpose of providing cash to pay federal estate taxes. The reduction of the federal estate tax and temporary repeal could result in policyholders reducing coverage under, or surrendering, these policies. See "Regulation -- U.S. Operations -- Tax Legislation".

#### CHANGES IN FEDERAL, STATE AND FOREIGN SECURITIES LAWS MAY REDUCE OUR PROFITABILITY.

Our asset management and accumulation and life insurance businesses are subject to various levels of regulation under federal, state and foreign securities laws. These laws and regulations are primarily intended to protect investors in the securities markets or investment advisory or brokerage clients and generally grant supervisory agencies broad administrative powers, including the power to limit or restrict the conduct of business for failure to comply with such laws and regulations. Changes to these laws or regulations that restrict the conduct of our business could reduce our profitability.

#### WE MAY EXPERIENCE VOLATILITY IN NET INCOME DUE TO CHANGES IN STANDARDS FOR ACCOUNTING FOR DERIVATIVES.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 133 will require us to include all derivatives in our consolidated statement of financial position at fair value. The accounting for changes in the fair value of a derivative depends on its intended use. Changes in derivative fair values will either be recognized in earnings as offsets to the changes in fair value of related hedged assets, liabilities and firm commitments or, for forecasted transactions, deferred and recorded as a component of equity until the hedged transactions occur and are recognized in earnings. The ineffective portion of a hedging derivative's change in fair value will be immediately recognized in earnings. Derivatives not used in hedging activities must be adjusted to fair value through earnings. We adopted SFAS 133 effective January 1, 2001. The cumulative effect of the application of SFAS 133 included a negative effect of \$10.7 million on net income and a negative effect of \$14.2 million on accumulated other comprehensive income. During the six months ended June 30, 2001, we recognized the change in value related to cash flow hedges in accumulated other comprehensive income, and reclassified a gain from accumulated other comprehensive income to earnings, which was offset by net losses on the assets or liabilities being hedged. These amounts were not material. The impact of the application of SFAS 133 on net income during the six months ended June 30, 2001 was \$28.0 million and the impact to accumulated other comprehensive income was \$(22.8) million.

#### WE MAY EXPERIENCE VOLATILITY IN NET INCOME DUE TO RECENT CHANGES IN STANDARDS FOR ACCOUNTING FOR BUSINESS COMBINATIONS, GOODWILL AND OTHER INTANGIBLE ASSETS.

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards Nos. 141, "Business Combinations" and 142, "Goodwill and Other Intangible Assets." Accordingly, our accounting for business combinations, goodwill and other intangible assets will change effective January 1, 2002. The accounting change includes the adoption of a non-amortization, impairment-only model for our goodwill and indefinite-lived intangible assets and a more stringent test methodology for measuring and recognizing impairment losses. The new statements require testing for impairment on an annual basis. Net income could be negatively impacted if



impairment losses are recognized. We are presently studying the impact the accounting change will have on our accounting policies, especially with regard to BT Financial Group.

A CHALLENGE TO THE INSURANCE COMMISSIONER OF THE STATE OF IOWA'S APPROVAL OF THE PLAN OF CONVERSION COULD PUT THE TERMS OF OUR DEMUTUALIZATION IN QUESTION AND REDUCE THE MARKET PRICE OF OUR COMMON STOCK.

After a public hearing, the Insurance Commissioner of the State of Iowa must determine whether to approve the plan of conversion. To approve the plan, the Insurance Commissioner of the State of Iowa must find that the plan meets the standards of Iowa law governing demutualizations, including, among other things, whether the plan is fair and equitable to Principal Mutual Holding Company and policyholders of Principal Life. The public hearing was held on July 25, 2001 and the Insurance Commissioner of the State of Iowa approved the plan on August 28, 2001. The order of the Insurance Commissioner of the State of Iowa approving the plan did not address the fairness of the plan to purchasers of common stock in the offering.

The Iowa law governing the demutualization provides that an action challenging the order of the Insurance Commissioner of the State of Iowa approving the plan can be filed, within the limitation period provided under Iowa law, after the Insurance Commissioner issues her order. The existence of a challenge to the plan or to the Insurance Commissioner's order approving the plan could reduce the market price of our common stock. A successful challenge could result in monetary damages, a modification of the plan or the Insurance Commissioner's approval of the plan being set aside. In addition, a successful challenge could result in substantial uncertainty relating to the terms and effectiveness of the plan, and an extended period of time might be required to reach a final determination. Such an outcome would likely reduce the market price of our common stock.

A lawsuit was filed on September 27, 2001 in the United States District Court for the Northern District of Illinois, seeking damages and other relief on behalf of a putative class of policyholders based on allegations that the plan of conversion violates the United States Constitution. The action is captioned Esther L. Gayman v. Principal Mutual Holding Company, et al. We believe that there are meritorious defenses to the plaintiff's claims and we intend vigorously to contest all of the plaintiff's claims. We are not presently aware of any other lawsuits challenging the plan. There can be no assurance, however, that additional lawsuits will not be commenced.

LITIGATION AND REGULATORY INVESTIGATIONS MAY HARM OUR FINANCIAL STRENGTH AND REDUCE OUR PROFITABILITY.

We are a plaintiff or defendant in actions arising out of our insurance business and investment operations. We are, from time to time, also involved in various governmental and administrative proceedings. This litigation may harm our financial strength and reduce our profitability.

Life insurance companies have historically been subject to substantial litigation resulting from claims disputes and other matters. Most recently, they have faced extensive claims, including class-action lawsuits, alleging improper life insurance sales practices. Negotiated settlements of such class-action lawsuits have had a material adverse effect on the business, financial condition and results of operations of other life insurance companies. Principal Life is currently a defendant in two purported class-action lawsuits alleging improper sales practices. We have reached an agreement in principle to settle both of those lawsuits. The settlement has received court approval. We have established reserves at a level we believe sufficient to cover the cost of the settlement. A number of persons and entities who were eligible to be class members have excluded themselves from the class (or "opted out"), as the law permits them to do. We have been notified that some of those who opted out from the class will file lawsuits and make claims similar to those addressed by the settlement. Similar opt-out lawsuits have been brought against other life insurance companies as a result of settlement of similar class-action lawsuits. Defense of these lawsuits may cause us to incur significant costs. At this time, we are not able to estimate the number of such lawsuits that may be filed, the costs of defending the lawsuits or whether our defense will be successful.

SALES OF SHARES DISTRIBUTED IN THE DEMUTUALIZATION MAY REDUCE THE MARKET PRICE OF OUR COMMON STOCK.

Substantially all of our shares of common stock distributed in the demutualization and this offering will be freely tradable. Sales of substantial amounts of common stock, or the perception that such sales could occur, could reduce the prevailing market price for our common stock. We believe the following factors may increase selling pressure on our common stock:

- Some policyholders, in particular owners of larger policies, who elect to receive cash instead of common stock as compensation in the demutualization may nevertheless receive common stock compensation if there is insufficient cash available for cash payment to policyholders. Those policyholders who elected to receive cash instead of common stock may be especially likely to sell the shares of common stock they received in the demutualization to realize cash proceeds.
- Some policyholders may be fiduciaries of pension plans that are subject to the Employee Retirement Income Security Act of 1974, or ERISA, trusts that own individual life insurance policies or welfare benefit plans. Those policyholders, particularly if they did not elect to receive common stock as compensation in the demutualization,

may determine that the exercise of their fiduciary duties requires them to promptly sell the shares of common stock they received in the demutualization.

APPLICABLE LAWS AND OUR STOCKHOLDER RIGHTS PLAN, CERTIFICATE OF INCORPORATION AND BY-LAWS MAY DISCOURAGE TAKEOVERS AND BUSINESS COMBINATIONS THAT OUR STOCKHOLDERS MIGHT CONSIDER IN THEIR BEST INTERESTS.

State laws and our certificate of incorporation and by-laws may delay, defer, prevent, or render more difficult a takeover attempt that our stockholders might consider in their best interests. For instance, they may prevent our stockholders from receiving the benefit from any premium to the market price of our common stock offered by a bidder in a takeover context. Even in the absence of a takeover attempt, the existence of these provisions may adversely affect the prevailing market price of our common stock if they are viewed as discouraging takeover attempts in the future.

State laws and our certificate of incorporation and by-laws may also make it difficult for stockholders to replace or remove our management. These provisions may facilitate management entrenchment which may delay, defer or prevent a change in our control, which may not be in the best interests of our stockholders.

Under the Iowa insurance laws, for a period of five years following the effective date of the demutualization, no person may acquire beneficial ownership of more than 5% of the outstanding shares of our common stock without the prior approval of the Insurance Commissioner of the State of Iowa and our board of directors. The Insurance Commissioner of the State of Iowa and our board of directors may consider the following factors:

- the effects of the action on our stockholders;
- the effects of the action on our employees, suppliers, creditors and customers;
- the effects of the action on the communities in which we operate;
- our long-term as well as short-term interests; and
- the long-term as well as short-term interests of our stockholders.

This restriction does not apply to acquisitions made by us or made through an employee benefit plan or employee benefit trust sponsored by us.

The following provisions, included in our certificate of incorporation and by-laws, may also have anti-takeover effects and may delay, defer or prevent a takeover attempt that our stockholders might consider in their best interests. In particular, our certificate of incorporation and by-laws:

- permit our board of directors to issue one or more series of preferred stock;
- divide our board of directors into three classes;
- limit the ability of stockholders to remove directors;
- prohibit stockholders from filling vacancies on our board of directors;
- prohibit stockholders from calling special meetings of stockholders;
- impose advance notice requirements for stockholder proposals and nominations of directors to be considered at stockholder meetings; and
- require the approval by the holders of at least 75% of our outstanding common stock for the amendment of our by-laws and provisions of our certificate of incorporation governing:
  - the classified board,
  - the director's discretion in determining what he or she reasonably believes to be in the best interests of Principal Financial Group, Inc.,
  - the liability of directors, and
  - the elimination of stockholder actions by written consent.

In addition, Section 203 of the General Corporation Law of the State of Delaware may limit the ability of an "interested stockholder" to engage in business combinations with us. An interested stockholder is defined to include persons owning 15% or more of our outstanding voting stock.

Our stockholder rights plan may have anti-takeover effects. The stockholder rights plan is designed to protect our stockholders in the event of unsolicited offers to acquire us and other coercive takeover tactics which, in the opinion of our board of directors, could impair the board's ability to represent stockholder interests. Our stockholder rights plan

might render an unsolicited takeover more difficult or less likely to occur, even though such a takeover might offer our stockholders the opportunity to sell their stock at a price above the prevailing market price and may be favored by our stockholders.

See "Description of Capital Stock and Change of Control Related Provisions" for additional information on the anti-takeover measures applicable to us.

THE IMPACT OF RECENT TERRORIST ATTACKS AND POSSIBLE MILITARY AND OTHER ACTIONS MAY RESULT IN DECREASES IN OUR NET INCOME, REVENUE AND ASSETS UNDER MANAGEMENT AND MAY ADVERSELY AFFECT OUR INVESTMENT PORTFOLIO.

Terrorist attacks in New York City and Washington, D.C. on September 11, 2001 disrupted commerce throughout the U.S., resulted in significant loss of life and caused significant volatility and declines in U.S., European, Australian and other securities markets. The continued threat of terrorism within the U.S. and Europe, and the potential for military action and heightened security measures in response to that threat, may cause additional disruptions to commerce, reduced economic activity and continued volatility in markets throughout the world. The impact of the events of September 11, 2001 has reduced our assets under management as a result of the declines in the U.S., Australian and other stock markets. These declines in the securities markets and reduced commercial and economic activity may also decrease our net income and revenue. See "-- A decline or increased volatility in the securities markets could result in investors withdrawing from the markets or decreasing their rates of investment, either of which could reduce our net income, revenues and assets under management."

Some of the assets in our investment portfolio may also be adversely affected by the declines in the securities markets and economic activity caused by the terrorist attacks and possible military action and heightened security measures. See "-- Our investment portfolio is subject to several risks which may diminish the value of our invested assets and affect our sales, profitability and the investment returns credited to our customers." For example, as of September 30, 2001, we held corporate fixed maturity securities in the following sectors (carrying amounts noted in parenthesis): airlines (\$258.0 million in public debt and \$202.6 million in private debt), comprised mostly of equipment trust certificate transactions secured by aircraft; airline manufacturers and equipment providers (\$248.2 million), comprised of public and private unsecured debt; property and casualty insurance companies(\$29.8 million), comprised of public and private unsecured debt; and hotels and gaming companies (\$168.0 million), comprised of public and private debt secured by hotel properties. As of September 30, 2001, we had gross unrealized gains and losses in the following sectors: airlines (\$8.0 million loss in public debt and \$8.0 million loss in private debt), airline manufacturers and equipment providers (\$15.5 million gain), property and casualty insurance companies (\$1.5 million gain), and hotels and gaming companies (\$1.7 million gain). We have not recognized any related impairment of these assets. However, we cannot predict at this time any losses that these sectors may suffer as a result of the decreased commercial and economic activity or how any such decrease might impact the obligor's ability to pay interest or principal on such securities or might affect the value of any underlying collateral. For example, it is possible that the continued significantly lower level of airline travel could affect the value of some of the airplane collateral underlying the equipment trust certificates as airlines retire aging aircraft. Any such losses, inability to pay or devalued collateral, may lead to possible write-downs, loss of value or impairments of the securities issued by companies affected by these events. Credit rating agencies have downgraded, and may in the future downgrade, some of these companies, as a result of the impacts of the terrorist attacks. In addition, declines in the securities markets and reduced commercial and economic activity may impact our assumptions in assessing the value of intangibles from prior acquisitions and the amortization patterns for deferred policy acquisition costs. In the event there is a need to change our assumptions, this may lead to a material impairment of these assets. See "-- We may experience volatility in net income due to recent changes in standards for accounting for business combinations, goodwill and other intangible assets."

In our Life and Health Insurance segment, we estimate our losses from insurance claims from the September 11(th) attacks, primarily individual life insurance claims, to be between \$9.0 million and \$12.0 million after taxes, taking into consideration reinsurance coverage. We do not engage in any property and casualty insurance or any reinsurance businesses.



## STATISTICAL INFORMATION SOURCES

This prospectus includes statistical data regarding the asset management and accumulation, life and health insurance and mortgage banking industries.

- Statistical data regarding industry growth projections of, as well as our market share within, the pension industry are based on information prepared by the Spectrem Group, a pension consulting organization. Spectrem Group data regarding our market share within the pension industry exclude all employers with fewer than 5 employees. Spectrem Group projections are based on its assumptions as of July 2001.
- Statistical data regarding our market share within the 401(k) plan market are derived from information collected through surveys conducted by CFO magazine, a monthly magazine offering coverage of business issues from the perspective of the senior financial officer.
- Statistical data regarding our use of information technology are provided by InformationWeek Magazine, a weekly publication reporting on the use of technology in business.
- Statistical data regarding the group insurance, annuity, guaranteed investment contract and funding agreement industries are based on information reported to LIMRA International, Inc., a financial services industry marketing research organization. LIMRA International, Inc. rankings are based on data provided by U.S. companies in connection with LIMRA International, Inc. conducted surveys.
- Statistical data comparing the investment performance of some of our mutual funds and separate accounts to our competitors are provided by Morningstar, an independent provider of financial information concerning mutual fund performance and the Investment Company Institute, the national association of the American investment company industry.
- Statistical data regarding the Australian asset management and accumulation industries are based on information reported to ASSIRT, an Australian investment research firm.
- Statistical data regarding the growth of Australian superannuation assets are provided by Cerulli Associates, Inc., a Boston- and London-based research and consulting firm that specializes in financial institutions. Cerulli Associates, Inc. projections are based on its assumptions as of March 2000.
- Statistical data regarding the performance of our margin lending business in Australia are provided by Cannex, an Australian margin lending rating agency.
- Statistical data regarding the group life and health insurance industry are based on information provided by the 1999 Life and Health Statistical report of National Underwriter, a weekly publication servicing the insurance and financial services industries.
- Statistical data regarding the mortgage banking industry are based on information provided by Inside Mortgage Finance, a weekly newsletter reporting on the residential mortgage industry, and by the 1999 Cost of Servicing Survey conducted by the Mortgage Bankers Association of America, an association representing the interests of members of the real estate finance industry.
- Statistical data regarding the performance of our commercial mortgages and information regarding our equity real estate portfolio are provided by the American Council of Life Insurers, an organization representing the interests of members of the life insurance industry.
- Statistical data regarding the mutual fund industry are based on information provided by the 2001 Mutual Fund Fact Book of the Investment Company Institute, an investment company industry organization.

The organizations gathering such data use methodology and conventions that they deem appropriate to measure the companies within the relevant industry segment. These organizations generally indicate that they have obtained information from sources believed to be reliable, but do not guarantee the accuracy and completeness of such information. While we believe this information to be reliable, we have not independently verified such data.

## THE DEMUTUALIZATION

In the following section, we provide a summary of the demutualization and of the plan of conversion. The following is just a summary, and is qualified by reference to the actual terms of the plan of conversion. A copy of the plan of conversion has been filed as an exhibit to the registration statement of which this prospectus forms a part.

### THE PLAN OF CONVERSION

#### ADOPTION AND APPROVAL OF THE PLAN OF CONVERSION

The board of directors of Principal Mutual Holding Company unanimously adopted the plan of conversion on March 31, 2001. The principal feature of the plan of conversion is the conversion of Principal Mutual Holding Company from a mutual insurance holding company into a stock company, a form of conversion known as "demutualization".

Because Principal Mutual Holding Company is a mutual insurance holding company organized under the laws of the State of Iowa, the demutualization is governed by Iowa law. Iowa law requires that the plan of conversion be approved by the policyholders entitled to vote on the plan of conversion by two-thirds of the votes cast, and also by the Insurance Commissioner of the State of Iowa.

The policyholders entitled to vote on the plan of conversion approved the plan of conversion at a meeting held on July 24, 2001, by approximately 92% of the votes cast.

The plan of conversion will not become effective unless, after conducting a public hearing on the plan of conversion, the Insurance Commissioner of the State of Iowa approves it based on a finding, among other things, that the plan of conversion is fair and equitable to Principal Mutual Holding Company and the policyholders of Principal Life. The public hearing was held on July 25, 2001 and the Insurance Commissioner of the State of Iowa approved the plan of conversion on August 28, 2001. See "Risk Factors -- A challenge to the Insurance Commissioner of the State of Iowa's approval of the plan of conversion could put the terms of our demutualization in question and reduce the market price of our common stock." In addition, the effectiveness of the demutualization and the closing of this offering are conditioned on their simultaneous occurrence.

#### STEPS TO DEMUTUALIZATION

We are currently a wholly-owned subsidiary of Principal Mutual Holding Company. The demutualization of Principal Mutual Holding Company includes the following steps, all of which will occur on the date of the closing of this offering:

- Principal Mutual Holding Company will convert from a mutual insurance holding company into a stock company;
- all membership interests of Principal Life's policyholders in Principal Mutual Holding Company will be extinguished;
- the converted Principal Mutual Holding Company will merge with and into Principal Iowa Newco, Inc.;
- Principal Financial Group, Inc., an Iowa business corporation and subsidiary of Principal Mutual Holding Company, will merge with and into Principal Iowa Newco, Inc.;
- Principal Financial Services, Inc., an Iowa business corporation, will merge with and into Principal Iowa Newco, Inc., and Principal Iowa Newco, Inc. will change its name to "Principal Financial Services, Inc.";
- we will sell shares of our common stock to the public in this offering;
- policyholders entitled to receive compensation in the demutualization will receive shares of our common stock, cash or policy credits as compensation for the extinguishment of their membership interests in Principal Mutual Holding Company no later than 75 days after the closing of this offering, unless the Insurance Commissioner of the State of Iowa approves a later date; and
- we will contribute to Principal Financial Services, Inc., and Principal Financial Services, Inc. will contribute to Principal Life, all or a portion of the net proceeds from this offering, as described in "Use of Proceeds".

In addition to this offering, we may also conduct a private placement of our common stock, a private placement or public offering of convertible preferred stock, a private placement or public offering of debt or seek other sources of capital. The primary purpose of any of these capital raising transactions would be to fund cash and policy credit elections.

When the demutualization and this offering are complete, we will be a Delaware public company. We will own 100% of the stock of Principal Financial Services, Inc., and Principal Financial Services, Inc. will own 100% of the stock of Principal Life and other operating subsidiaries of the Principal Financial Group.

The following chart illustrates our corporate structure prior to and following the demutualization:

[STRUCTURE BEFORE & AFTER DEMUTUALIZATION GRAPHS]

EFFECTIVE DATE

The demutualization will become effective on the date of the closing of this offering. The plan of conversion provides that the effective date will occur after the approval by the policyholders entitled to vote on the plan of conversion and the Insurance Commissioner of the State of Iowa, but on or before 12 months after the date on which the Insurance Commissioner of the State of Iowa approves the plan of conversion. With the approval of the Insurance Commissioner of the State of Iowa, the effective date deadline may be extended.

## ADDITIONAL REVIEW AND APPROVAL

Our plan of conversion is also subject to review by the New York Superintendent of Insurance, who may raise objections if he determines that its provisions are unfair or inequitable to New York policyholders. The New York Superintendent of Insurance has not raised any such objections as of the date of this prospectus. The Department of Labor has published notice in the Federal Register of an order granting prohibited transaction exemptions under ERISA. A more complete description of these exemptions is provided under the heading "-- ERISA Considerations".

## PAYMENT OF CONSIDERATION TO ELIGIBLE POLICYHOLDERS

### AMOUNT AND FORM OF CONSIDERATION

Until the effective date of the demutualization, Principal Mutual Holding Company is a mutual insurance holding company governed by its members, who are policyholders of Principal Life. In connection with the demutualization, the membership interests of Principal Life policyholders in Principal Mutual Holding Company will be extinguished, and policyholders entitled to receive compensation in the demutualization will receive compensation in exchange for the extinguishment of their membership interests.

Policyholders entitled to receive compensation in the demutualization are those persons who:

- owned on March 31, 2000 a Principal Life policy or contract and who had a continuous membership interest in Principal Mutual Holding Company through ownership of a Principal Life policy or contract from March 31, 2000 until the date of the closing of this offering; or
- were issued a Principal Life policy or contract on or before April 8, 1980 and transferred ownership rights of that policy or contract on or before April 8, 1980, so long as that policy or contract remains in force until the date of the closing of this offering.

Whether or not a policy or contract is in force is determined based upon our records. In general, a policy or contract is in force on a given day if it has been issued and is in effect, has not matured by death or otherwise or been surrendered or otherwise terminated, and verbal or written notice of the insured's death has not been received by Principal Life. A policy is generally not in force until it is issued and is in effect. However, a policy is considered to be in force if we have received at our administrative office an application complete on its face or payment of the full initial premium, or such lesser amount required by our normal administrative procedures, together with sufficient information to effect a contract of insurance according to our normal administrative procedures for coverage to be effective, provided that such policy is later issued in accordance with the terms of its application.

The compensation will consist of a fixed component equal to 100 shares of common stock for each policyholder entitled to receive compensation in the demutualization, and a variable component of additional shares allocated, based on actuarial formulas described in our plan of conversion and the actuarial contribution memorandum. The actuarial formulas take into account a policy's past and estimated future contributions to the surplus and asset valuation reserve of Principal Life.

The compensation will be in the form of either policy credits, cash or shares of our common stock. In the case of the MANDATORY POLICY CREDITS, policy credits are either an increase in cash value, account value, dividend accumulations, face amount, extended term period or benefit payment, as appropriate, depending on the policy. In the case of group policies, policy credits are either SEPARATE ACCOUNT POLICY CREDITS or Account Value Policy Credits. The form of compensation will be determined as follows:

**POLICY CREDITS.** The following types of policies will be required to receive or be eligible for policy credits:

- If the policy is required to receive Mandatory Policy Credits, the policy credits may take the form of an increase in cash value, account value, dividend accumulations, face amount, extended term period or benefit payment, as appropriate, depending on the policy. The following types of policies are required to receive Mandatory Policy Credits:
  - Individual retirement annuity contracts under Section 408(b) or Section 408A of the Internal Revenue Code.
  - Tax sheltered annuity contracts under Section 403(b) of the Internal Revenue Code.
  - Individual annuity contracts issued directly to a plan participant under a plan qualified under Section 401(a) or Section 403(a) of the Internal Revenue Code.
  - Individual life insurance policies issued directly to a plan participant under a plan qualified under Section 401(a) or Section 403(a) of the Internal Revenue Code.
- If the policy is owned by a QUALIFIED PLAN CUSTOMER, the policy credit may take the form of Separate Account Policy Credits, which may be allocated to participants under the policy. A Qualified Plan Customer may elect common stock or, subject to the limits described in the plan of conversion, Account Value Policy Credits or cash



as consideration rather than Separate Account Policy Credits. If no election is made, such Qualified Plan Customer will receive Separate Account Policy Credits. However, Qualified Plan Customers whose group annuity contracts were issued in California will not be eligible for Separate Account Policy Credits. Instead, they are eligible to receive common stock or, subject to the limits described in the plan of conversion, Account Value Policy Credits or cash. If no election is made, Qualified Plan Customers whose group annuity contracts were issued in California will receive common stock.

- If the policy is owned by a NON-RULE 180 QUALIFIED PLAN CUSTOMER, the policy credit may take the form of an Account Value Policy Credit, which may be allocated to participants under the policy. A Non-Rule 180 Qualified Plan Customer may elect to receive common stock or, subject to the limits described in the plan of conversion, cash as consideration rather than Account Value Policy Credits. If no election is made, such Non-Rule 180 Qualified Plan Customer will receive Account Value Policy Credits.

CASH. The following types of policies will be eligible solely for cash:

- Policies for which the mailing address of the policyholder on Principal Life's or Principal Mutual Holding Company's records is one at which mail is undeliverable.
- Policies for which the mailing address of the policyholder on Principal Life's or Principal Mutual Holding Company's records is located outside the United States.
- Policies for which it is not reasonably feasible or appropriate to provide consideration in the form that policyholders would otherwise receive.

All policyholders who are entitled to receive shares of our common stock will be permitted, prior to the vote of the policyholders entitled to vote on the plan of conversion, to express a preference to receive cash, rather than common stock, as consideration for the extinguishment of their membership interests. Cash will be distributed to such policyholders to the extent available. Eligible policyholders that elect cash and are allocated 100 shares or fewer will receive cash. See "-- Limits on Amount Available for Cash, Account Value Policy Credits and Separate Account Policy Credits Compensation".

COMMON STOCK. Except for policies which are eligible solely for Mandatory Policy Credits or cash, all eligible policies will be eligible for shares of our common stock.

#### CALCULATION OF COMPENSATION

COMMON STOCK. Policyholders receiving common stock as compensation will receive the number of shares of common stock ultimately allocated to them. The value of each share of common stock will be equal to its public trading price on any particular day.

CASH AND POLICY CREDITS (OTHER THAN SEPARATE ACCOUNT POLICY CREDITS). Policyholders receiving cash or policy credits, other than Separate Account Policy Credits, will receive an amount equal to the number of shares of common stock that are allocated to them multiplied by the price per share at which the common stock is sold in this offering.

SEPARATE ACCOUNT POLICY CREDITS. Policyholders receiving Separate Account Policy Credits will receive an amount equal to their respective share of the assets in the separate account holding shares of our common stock and maintained by Principal Life. Because our common stock will initially be the only asset in this separate account, any policyholder's share of the assets when the separate account is initiated will be equal to the number of shares of our common stock allocated to that policyholder multiplied by the public trading price of our common stock at that time. See "-- Operation of the Separate Account Holding Shares of our Common Stock".

#### LIMITS ON AMOUNT AVAILABLE FOR CASH, ACCOUNT VALUE POLICY CREDITS AND SEPARATE ACCOUNT POLICY CREDITS COMPENSATION

Each policyholder who is eligible to receive common stock will have an opportunity to elect cash. If cash is not elected by such policyholder, a preference for common stock will be assumed, unless such policyholder is a Qualified Plan Customer or a Non-Rule 180 Qualified Plan Customer.

There may be a limit to the amount of funds available to pay cash and provide Account Value Policy Credits to eligible policyholders allocated more than 100 shares of common stock under our plan of conversion. It is possible that the total funds raised in this offering and the other capital raising transactions, if applicable, will not be sufficient to fund cash distributions or Account Value Policy Credits for all of the eligible policyholders who have been allocated more than 100 shares of common stock and who have elected cash, or elected or are deemed to have elected Account Value Policy Credits. However, eligible policyholders who are allocated 100 or fewer shares of common stock will receive cash or Account Value Policy Credits, if they so elect or are deemed to so elect.

In the event that the total available funds are not sufficient, the available funds will be distributed to those expressing a preference for cash or Account Value Policy Credits based on the number of shares of common stock that would be distributed to each electing policyholder, progressing from the smallest number of shares to the largest number at which all policyholders electing cash or Account Value Policy Credits can be accommodated.

Qualified Plan Customers whose cash or Account Value Policy Credit preferences cannot be satisfied will instead receive Separate Account Policy Credits. Non-Rule 180 Qualified Plan Customers and Qualified Plan Customers whose group annuity contracts were issued in California whose cash or Account Value Policy Credit preferences cannot be satisfied will instead receive shares of our common stock.

The maximum number of allocated shares for which cash or Account Value Policy Credits will be available will depend on a number of factors. These factors include the number of policyholders eligible for common stock, Mandatory Policy Credits or cash, the size of the initial public offering, the initial public offering stock price, the size of any other capital raising transaction, if applicable, and the percentage of policyholders who elect to receive cash or Account Value Policy Credits.

In addition, the amount of Separate Account Policy Credits will be limited so that no less than 50% of the total consideration distributed to policyholders entitled to receive compensation in the demutualization will be in the form of common stock.

#### ACTUARIAL OPINION

Principal Mutual Holding Company retained Milliman USA ("Milliman"), formerly named Milliman & Robertson, Inc., an independent actuarial consulting firm, to advise it in connection with actuarial matters involved in the development of the plan of conversion and the payment of consideration to policyholders entitled to receive compensation in the demutualization. The opinion of Daniel J. McCarthy, F.S.A., an independent consulting actuary associated with Milliman, dated March 31, 2001, states, in reliance upon the matters described in such opinion, that the principles, assumptions and methodologies used to allocate the consideration among policyholders entitled to receive compensation in the demutualization are reasonable and appropriate and result in an allocation of consideration that is fair and equitable to these policyholders. A copy of the opinion is attached as Annex A to this prospectus.

#### OPERATION OF THE SEPARATE ACCOUNT HOLDING SHARES OF OUR COMMON STOCK

We estimate that 56.2 million shares of our common stock may be issued to a new separate account of Principal Life in connection with funding the Separate Account Policy Credits. As described above, these shares will be held in the separate account for the benefit of Qualified Plan Customers and may be sold in the market from time to time as a result of instructions from the Qualified Plan Customers holding interests in this separate account. If not directed otherwise by the Qualified Plan Customer, the separate account interests owned by that Qualified Plan Customer may also be allocated to participants' benefit plan accounts under the applicable policy. Dividends with respect to these shares will be paid to Principal Life and allocated to the separate account. The Qualified Plan Customer may request Principal Life to transfer the value of its interest in the separate account to Principal Life's general account or to another account for investment purposes. Principal Life will have no right to use the assets of the separate account for any obligation or purpose other than those relating to the group annuity contracts under which the assets in the separate account will be held.

Principal Life will hold legal title to these shares in a fiduciary capacity. The Qualified Plan Customers will remain the beneficial owners of these shares and be able to exercise voting rights. The plan of conversion provides that Principal Life, as record holder of the shares held in the separate account, will solicit voting instructions from the Qualified Plan Customers holding interests in the separate account and will vote the shares as instructed.

If the Qualified Plan Customer fails to provide instructions to Principal Life, the non-directed shares (the shares as to which Principal Life has received no instruction) will be voted as follows:

- if the matter involved is routine, Principal Life will vote the non-directed shares under a "mirror voting" provision, in other words the non-directed shares will be voted in the same proportion, either for, against or abstain, as the shares in the separate account for which Principal Life has received instructions; or
- if the matter involved is not routine, an independent fiduciary appointed by Principal Life will instruct Principal Life to vote the non-directed shares in a way that, in the independent fiduciary's judgment, would be in the best interest of the participants and beneficiaries of the benefits plans of Qualified Plan Customers in whose interest such shares are held; Principal Life will retain fiduciary responsibility as to these matters, and the independent fiduciary will in effect act as Principal Life's agent.

Routine matters refer to matters within the ordinary course of the business of the corporation and its stockholders, such as the election of directors at an annual meeting. Non-routine matters refer to fundamental corporate decisions outside the ordinary course of the business of the corporation and its stockholders, such as a potential change of control.

Principal Life expects to appoint as independent fiduciary a major financial institution with investment management expertise. These voting procedures will be set forth in an agreement between Principal Life and the independent fiduciary as well as in the plan of operation for the separate account.

In our future consolidated financial statements, we will report the shares of our common stock held by the new separate account of Principal Life as an investment of the separate account, and will establish a corresponding separate account liability, based on the fair value of those shares, for the amounts owed to the Qualified Plan Customers under the related group variable annuity contracts. This is consistent with the accounting under generally accepted accounting principles for other separate accounts where all investment risks and rewards are borne by the contractholders. Generally accepted accounting principles accord special accounting treatment to group variable annuity contracts issued by separate accounts, recognizing that such contracts provide contractholders with virtually all the rights of ownership except legal title to the shares held in the separate account and therefore company shares held in a subsidiary's separate account need not be accounted for as treasury stock.

#### THE CLOSED BLOCK

At the time our existing pre-demutualization mutual insurance holding company structure was created in 1998, for policy dividend purposes only, Principal Life formed and began operating a Closed Block for the benefit of individual policies paying experience-based policy dividends. For accounting purposes only, assets of Principal Life were allocated to the Closed Block in an amount that produces cash flows which, together with anticipated revenue from the Closed Block policies and contracts, were expected to be sufficient to support the Closed Block policies including, but not limited to, provisions for payment of claims, expenses, charges and taxes, and to provide for continuation of policy and contract dividends in aggregate in accordance with the 1997 dividend scales, if the experience underlying such scales continues, and to allow for appropriate adjustments in such scales, if such experience changes. Assets in the Closed Block remain as general account assets of Principal Life and are fully subject to the claims of creditors of Principal Life, like any general account assets. The Closed Block continues in existence as established and will not be affected by the demutualization. No additional policies will be added to the Closed Block as a result of the demutualization.

#### LIMITATIONS ON ACQUISITION AND DISPOSITION OF SECURITIES BY OFFICERS AND DIRECTORS

No officer, director or employee will receive stock or cash compensation at the time of the demutualization other than what he or she may receive as a policyholder entitled to receive compensation in the demutualization or as a plan participant of a policyholder entitled to receive compensation in the demutualization.

Until six months after the completion of the demutualization, we may not award any stock options, stock grants or other stock-based grants to any of our executive officers or directors, our executive officers and directors and their families may not purchase shares of our common stock, and our executive officers and directors may not receive distributions of stock under our long-term performance plan. Until eighteen months after the completion of the demutualization, we may not issue any shares of our common stock to a participant under our excess plan (our non qualified retirement savings plan). No stock incentive awards to our executive officers and no awards to our directors may become exercisable or distributable earlier than eighteen months after the completion of the demutualization, except in cases of death or disability or, in limited circumstances, with the approval of the Insurance Commissioner of the State of Iowa. These restrictions apply not only to those who are "executive officers" within the meaning given that term in the Securities Exchange Act of 1934, but also to the officers of any of our affiliated companies or subsidiaries with a title of Second Vice President or a more senior title, whom we refer to in the plan of conversion as our "executive officers."

These limitations do not prevent us from issuing common stock:

- in connection with our employees savings plan, our agents savings plan, any employee stock ownership plan or other employee benefit plan established for the benefit of our employees and qualified under the Internal Revenue Code; or
- to match contributions by employees to any such plan.

Further, our stock incentive plan allows us to issue shares of common stock to our employees other than our executive officers and directors, as well as to our agents, but not before 30 days after the completion of the demutualization.

We may issue shares of common stock, options or other stock-based incentives pursuant to our stock incentive plan, the long-term performance plan, the directors stock plan and the excess plan, although the maximum number of shares of common stock that may be issuable under all such plans, and any new plan awarding our common stock, during the five year period after the completion of the demutualization, is 6% of the number of shares outstanding immediately following the completion of the demutualization, unless the shareholders vote to increase such maximum number. The number of shares that may be awarded in the eighteen months following the completion of the



demutualization is limited to 40% of such maximum. These limitations are not applicable to three plans: our employee stock purchase plan, pursuant to which we may issue up to 2% of the total number of shares outstanding immediately following the completion of the demutualization, our employees savings plan and our agents savings plan.

#### LIMITATIONS ON ACQUISITIONS OF OUR COMMON STOCK

Iowa law prohibits for a period of 5 years following the date of distribution of consideration to the policyholders in exchange for their membership interests:

- any person, other than the reorganized company, or other than an employee benefit plan or employee benefit trust sponsored by the reorganized company, from directly or indirectly acquiring or offering to acquire the beneficial ownership of more than 5% of any class of voting security of the reorganized company, and
- any person, other than the reorganized company, or other than an employee benefit plan or employee benefit trust sponsored by the reorganized company, who acquires 5% or more of any class of voting security of the reorganized company prior to the conversion, from directly or indirectly acquiring or offering to acquire the beneficial ownership of additional voting securities of the reorganized company,

unless the acquisition is approved by the Insurance Commissioner of the State of Iowa and by the board of directors of the reorganized company.

By virtue of these provisions, we may not be subject to an acquisition by another company during the 5 years following the distribution of consideration to policyholders entitled to receive compensation in the demutualization.

#### AMENDMENTS TO THE PLAN

The board of directors of Principal Mutual Holding Company may amend the plan of conversion at any time before the date of the closing of this offering with the approval of the Insurance Commissioner of the State of Iowa. The board of directors of Principal Financial Group, Inc. may amend the plan of conversion after the date of the closing of this offering with the approval of the Insurance Commissioner of the State of Iowa.

#### APPEAL

Under Iowa law, judicial review of a decision of the Insurance Commissioner of the State of Iowa may be sought by initiation of an action, within the limitation period provided under Iowa law, after the Insurance Commissioner of the State of Iowa issues her order approving the plan of conversion.

The Insurance Commissioner of the State of Iowa approved the plan of conversion on August 28, 2001.

A lawsuit was filed on September 27, 2001 in the United States District Court for the Northern District of Illinois, seeking damages and other relief on behalf of a putative class of policyholders based on allegations that the plan of conversion violates the United States Constitution. The action is captioned *Esther L. Gayman v. Principal Mutual Holding Company, et al.* We believe that there are meritorious defenses to the plaintiff's claims and we intend vigorously to contest all of the plaintiff's claims. We are not presently aware of any other lawsuits challenging the plan. There can be no assurance, however, that additional lawsuits will not be commenced.

#### ERISA CONSIDERATIONS

We and our subsidiaries provide a variety of fiduciary and other services to employee benefit plans that are also policyholders. The provision of such services may cause us to be a "party in interest" or "disqualified person," as such terms are defined in ERISA and the Internal Revenue Code, with respect to such plans. Unless an exemption is obtained from the Department of Labor, some transactions between parties in interest or disqualified persons and those plans are prohibited by ERISA and the Internal Revenue Code. We have applied to the Department of Labor for prohibited transaction exemptions under ERISA, which would, if granted, provide relief from the restrictions of ERISA and the Internal Revenue Code to permit policyholders entitled to receive compensation in the demutualization to receive common stock, cash or policy credits in accordance with the plan of conversion.

On September 27, 2001, the Department of Labor published notice in the Federal Register of an order granting the requested prohibited transaction exemptions with respect to the payment of compensation under the plan of conversion to policyholders entitled to receive compensation in the demutualization as to which we are a "party in interest" or "disqualified person." Such exemption is subject to various conditions, including the implementation of the plan of conversion in accordance with procedural and substantive safeguards that are imposed under the Iowa demutualization law and supervised by the Insurance Commissioner of the State of Iowa.

U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE DEMUTUALIZATION TO US

We have received a private letter ruling from the Internal Revenue Service to the effect that, among other matters:

- The conversion of Principal Mutual Holding Company from a mutual insurance holding company into a stock company will be treated as a "recapitalization" within the meaning of section 368(a)(1)(E) of the Internal Revenue Code;
- The merger of Principal Mutual Holding Company into Principal Iowa Newco, Inc. will not be prevented from qualifying as a "reorganization" within the meaning of section 368(a)(1)(A) or section 368(a)(2)(D) of the Internal Revenue Code by reason of Principal Mutual Holding Company's status as a "mutual insurance holding company" until immediately prior to such merger; and
- The affiliated federal income tax group of which Principal Mutual Holding Company is the common parent immediately before the consummation of the proposed transaction will remain in existence, with Principal Financial Group, Inc., a Delaware corporation and the issuer of our common stock, as the common parent.

We have received opinions of our special tax counsel, Debevoise & Plimpton, dated May 24, 2001, substantially to the effect that, under the federal income tax law and facts as they existed on the date of the opinion:

- Policies issued by Principal Life prior to the completion of the demutualization will not be deemed newly-issued policies for any material federal income tax purpose as a result of Principal Mutual Holding Company's conversion from a mutual insurance holding company into a stock company;
- Policyholders receiving solely shares of our common stock and Qualified Plan Customers whose policies are credited with Separate Account Policy Credits should not recognize income, gain or loss for federal income tax purposes as a result of the consummation of our demutualization;
- For policies that are tax sheltered annuities, individual retirement annuities, Roth IRAs or individual life insurance policies or annuity contracts issued to participants in qualified retirement plans, the completion of our demutualization, including the crediting of compensation in the form of policy credits, will not result in any transaction that will (1) be treated as a contribution or distribution that will result in penalties to the holder or that will be subject to withholding, (2) disqualify an individual retirement annuity policy or give rise to a prohibited transaction between the individual retirement annuity and the individual for whose benefit it is established, or his or her beneficiary, or (3) adversely affect the tax-favored status of these policies under the Internal Revenue Code or result in penalties or any other material adverse federal income tax consequences to the holders of these policies under the Internal Revenue Code;
- For policies that are part of a tax-qualified pension or profit-sharing plan described in section 401(a) or section 403(a) of the Internal Revenue Code and that will be credited with compensation in the form of policy credits, the completion of our demutualization, including the crediting of compensation in the form of policy credits, will not result in any transaction that will disqualify the plan, give rise to a prohibited transaction between the plan and the individual for whose benefit it is established, or his or her beneficiary, or otherwise adversely affect the tax-favored status of the policies under the Internal Revenue Code or result in penalties or any other material adverse federal income tax consequences to the holders of these policies under the Internal Revenue Code; and
- The summary of the principal federal income tax consequences to policyholders of their receipt of compensation under our plan of conversion, that is contained under the heading "U.S. Federal Income Tax Considerations" in the information booklet provided to policyholders, is, to the extent it describes matters of law or legal conclusions and subject to the limitations and assumptions described in it, an accurate summary of the material federal income tax consequences to policyholders of the consummation of our plan of conversion under the federal income tax law.

In order for us to complete our demutualization, our special tax counsel must confirm that each of these opinions continues to be true under the facts and federal income tax law as they exist on the date of the closing of this offering.

Based on the Internal Revenue Service rulings we have received and the opinions of our special tax counsel described above, we believe that the Principal Financial Group will not realize significant income, gain or loss for federal income tax purposes as a result of the consummation of the demutualization under the terms of the plan of conversion.

The private letter rulings we have received from the Internal Revenue Service and the opinions of special tax counsel described above are based on the accuracy of representations and undertakings made by us.

USE OF PROCEEDS

Our net proceeds from the offering will be \$1,753.3 million, or \$2,018.8 million if the underwriters exercise in full their option to purchase additional shares of common stock in the offering and after deducting underwriting discounts and commissions and the estimated expenses of the offering. The following table summarizes the use of these net proceeds, assuming the underwriters do not exercise their option to purchase additional shares of common stock in the offering:

USE OF PROCEEDS:	(\$ IN MILLIONS)
Cash contributed to Principal Life.....	\$1,693.8
Proceeds retained by Principal Financial Group, Inc. ....	59.5
	-----
Total net proceeds.....	\$1,753.3
	=====

The plan of conversion requires us to contribute all or a portion of the net proceeds to Principal Life to fund (1) policy credits and cash payments for policyholders for whom policy credits or cash are the required form of compensation; (2) the elections for cash and the elections or deemed elections for Account Value Policy Credits that are attributable to policyholders entitled to these forms of compensation; and (3) an amount equal to the fees and expenses of the demutualization paid by Principal Life. Under the plan of conversion, we may retain up to \$250.0 million of any remaining proceeds from this offering to be used for working capital, payment of dividends and other general corporate purposes. We must contribute any remaining proceeds, before any exercise of the underwriters' over-allotment option, in excess of this \$250.0 million limit to Principal Life.

In connection with the demutualization, Principal Life will require funds contributed by us to satisfy the following needs. As of the date of this prospectus:

- \$324.7 million is estimated to be necessary to provide compensation to policyholders eligible solely for cash or policy credits;
- \$1,329.5 million is estimated to be used to make elective cash payments and fund Account Value Policy Credits to policyholders receiving these forms of compensation in the demutualization; and
- \$39.6 million is estimated to be required for the cost of the nonrecurring expenses of Principal Life directly related to the demutualization.

In addition to the shares of our common stock distributed in this offering, for which we will receive cash proceeds, many policyholders entitled to receive compensation in the demutualization will receive shares of our common stock distributed in connection with the demutualization, as well as cash, Account Value Policy Credits or Separate Account Policy Credits, as compensation for extinguishment of their membership interests in Principal Mutual Holding Company. None of Principal Financial Group, Inc., Principal Financial Services, Inc. or Principal Life will receive any proceeds from the issuance of our common stock to policyholders entitled to receive compensation in the demutualization for the extinguishment of their membership interests in Principal Mutual Holding Company or to the separate account to be established for the Separate Account Policy Credits.

## STOCKHOLDER DIVIDEND POLICY

We currently intend to pay regular annual cash dividends on our common stock. We currently intend to declare an annual cash dividend of \$0.25 per share on our common stock. We expect that our first annual cash dividend will be a proportion of that amount, based on the number of months remaining in the calendar year in which we become public. Although we intend to pay dividends, the declaration and payment of dividends is subject to the discretion of our board of directors. The declaration, payment and amount of dividends will be dependent upon our results of operations, financial condition, cash requirements, future prospects, regulatory and other restrictions on the payment of dividends by our subsidiaries to us and other factors deemed relevant by our board of directors. There can be no assurance that we will declare and pay any dividends.

As a holding company, we will depend principally on dividends from Principal Life to satisfy our financial obligations, pay operating expenses and pay dividends to our stockholders.

If Principal Life is unable to pay stockholder dividends in the future, our ability to pay dividends to our stockholders and meet our cash obligations will be limited. The payment of dividends by Principal Life is subject to the discretion of its board of directors. In addition, the Iowa insurance laws limit how and when Principal Life can pay stockholder dividends. Principal Life was able to pay approximately \$760.9 million in statutory dividends in 2001 based on its 2000 statutory financial results without being subject to the restrictions on payment of extraordinary stockholder dividends, all of which as of August 24, 2001 has been declared and paid. See "Risk Factors -- Our ability to pay dividends and meet our obligations may be constrained by the limitations on dividends Iowa insurance laws impose on Principal Life", "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources", and Note 14 to our audited consolidated financial statements.

CAPITALIZATION

The following table provides, as of June 30, 2001, (1) our actual consolidated capitalization and (2) our pro forma capitalization after giving effect to:

- the demutualization and the issuance of 260.6 million shares of our common stock to policyholders entitled to receive compensation in the demutualization or to the separate account to be established for the Separate Account Policy Credits;
- the sale of 100.0 million shares of our common stock in this offering at an initial public offering price of \$18.50 per share; and
- the application of the net proceeds from this offering as described under "Use of Proceeds," as if the demutualization and this offering had occurred as of June 30, 2001.

We based the pro forma information on the assumptions we have made about the number of shares of common stock and the amount of cash and policy credits that will be distributed to policyholders entitled to receive compensation in the demutualization. We describe these assumptions in "Unaudited Pro Forma Condensed Consolidated Financial Information." You should read this table in conjunction with the Unaudited Pro Forma Condensed Consolidated Financial Information appearing in this prospectus.

The table below assumes that the underwriters' option to purchase additional shares of common stock in the offering is not exercised.

	AS OF JUNE 30, 2001	
	----- ACTUAL	PRO FORMA -----
	(\$ IN MILLIONS, EXCEPT PER SHARE AMOUNT)	
Debt:		
Short-term debt.....	\$ 675.9	\$ 675.9
Long-term debt.....	1,390.6	1,390.6
	-----	-----
Total debt.....	2,066.5	2,066.5
Equity:		
Common stock, \$0.01 par value; 2.5 billion shares authorized; 360.6 million shares issued and outstanding.....	--	3.6
Additional paid-in capital.....	--	6,628.7
Retained earnings.....	6,536.9	--
Accumulated other comprehensive loss.....	(8.5)	(8.5)
	-----	-----
Total equity.....	6,528.4	6,623.8
	-----	-----
Total capitalization.....	\$8,594.9	\$8,690.3
	=====	=====
Book value per common share.....		\$ 18.37
		=====

SELECTED HISTORICAL FINANCIAL INFORMATION

The following table provides summary historical consolidated financial information of Principal Mutual Holding Company, the predecessor to Principal Financial Group, Inc. prior to the demutualization, and will apply to Principal Financial Group, Inc. following the demutualization. We derived the consolidated financial information for each of the years ended December 31, 2000, 1999 and 1998 and as of December 31, 2000 and 1999 from our audited consolidated financial statements and notes to the financial statements included in this prospectus. We derived the consolidated financial information for the years ended December 31, 1997 and 1996 and as of December 31, 1998, 1997 and 1996 from our audited consolidated financial statements not included in this prospectus. We derived the summary consolidated financial information for the six months ended June 30, 2001 and 2000 and as of June 30, 2001, from our unaudited interim consolidated financial statements included in this prospectus. We derived the summary consolidated financial information as of June 30, 2000, from our unaudited interim consolidated financial statements not included in this prospectus. All unaudited interim consolidated financial information presented in the table below reflects all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of our consolidated financial position and results of operations for such periods. The results of operations for the six months ended June 30, 2001 are not necessarily indicative of the results to be expected for the full year. The following summary consolidated financial information, other than the Principal Life statutory data, has been prepared in accordance with GAAP.

The following is a summary and, in order to fully understand our consolidated financial information, you should also read "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the notes to the financial statements included in this prospectus. The results for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period.

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,				
	2001(2)	2000(2)	2000(2)	1999(2)	1998(2)	1997(2)	1996(2)
	(\$ IN MILLIONS)						
INCOME STATEMENT DATA:(1)							
Revenues:							
Premiums and other considerations.....	\$ 1,955.3	\$ 1,992.7	\$ 3,996.4	\$ 3,937.6	\$ 3,818.4	\$ 4,667.8	\$ 5,120.9
Fees and other revenues.....	856.3	783.2	1,576.3	1,287.3	978.8	881.9	722.4
Net investment income.....	1,686.0	1,558.1	3,172.3	3,072.0	2,933.9	2,936.6	2,894.0
Net realized capital gains (losses).....	(176.9)	31.5	139.9	404.5	465.8	175.3	387.8
Total revenues.....	4,320.7	4,365.5	8,884.9	8,701.4	8,196.9	8,661.6	9,125.1
Expenses:							
Benefits, claims and settlement expenses.....	2,639.2	2,631.1	5,232.3	5,260.9	5,089.0	5,632.5	6,086.5
Dividends to policyholders.....	162.1	155.8	312.7	304.6	298.7	299.3	298.5
Operating expenses.....	1,228.2	1,228.0	2,479.4	2,070.3	2,074.0	2,035.5	1,909.8
Total expenses.....	4,029.5	4,014.9	8,024.4	7,635.8	7,461.7	7,967.3	8,294.8
Income before income taxes and cumulative effect of accounting change.....	291.2	350.6	860.5	1,065.6	735.2	694.3	830.3
Income taxes.....	56.1	105.3	240.3	323.5	42.2	240.8	304.3
Income before cumulative effect of accounting change.....	235.1	245.3	620.2	742.1	693.0	453.5	526.0
Cumulative effect of accounting change, net of related income taxes.....	(10.7)	--	--	--	--	--	--
Net income.....	\$ 224.4	\$ 245.3	\$ 620.2	\$ 742.1	\$ 693.0	\$ 453.5	\$ 526.0

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,				
	2001(2)	2000(2)	2000(2)	1999(2)	1998(2)	1997(2)	1996(2)
	(\$ IN MILLIONS)						
BALANCE SHEET DATA:(1)							
Invested assets.....	\$44,403.2	\$41,224.9	\$42,090.6	\$41,343.2	\$40,686.7	\$39,572.2	\$38,658.3
Separate account assets.....	33,739.5	36,080.6	34,916.2	34,992.3	29,009.3	23,560.1	17,166.3
All other assets.....	7,087.0	7,040.8	7,398.1	7,617.7	4,350.7	4,002.9	3,358.7
Total assets.....	\$85,229.7	\$84,346.3	\$84,404.9	\$83,953.2	\$74,046.7	\$67,135.2	\$59,183.3
Policyholder liabilities.....							
Policyholder liabilities.....	\$39,159.4	\$37,412.4	\$38,243.6	\$37,808.9	\$35,885.1	\$35,306.1	\$34,766.3
Separate account liabilities.....	33,739.5	36,080.6	34,916.2	34,992.3	29,009.3	23,560.1	17,166.3
Short-term debt.....	675.9	390.7	459.5	547.3	290.9	313.7	198.5
Long-term debt.....	1,390.6	1,538.5	1,336.5	1,492.9	670.9	458.9	399.1
All other liabilities.....	3,735.9	3,290.3	3,196.6	3,558.9	2,523.3	2,212.2	1,998.6
Total liabilities.....	\$78,701.3	\$78,712.5	\$78,152.4	\$78,400.3	\$68,379.5	\$61,851.0	\$54,528.8
Retained earnings.....							
Retained earnings.....	\$ 6,536.9	\$ 5,937.6	\$ 6,312.5	\$ 5,692.3	\$ 4,950.2	\$ 4,257.2	\$ 3,803.7
Net unrealized gains (losses) on available-for-sale securities.....	268.6	(178.2)	129.9	(79.1)	745.9	1,037.5	859.7
Net foreign currency translation adjustment.....	(277.1)	(125.6)	(189.9)	(60.3)	(28.9)	(10.5)	(8.9)
Total equity.....	\$ 6,528.4	\$ 5,633.8	\$ 6,252.5	\$ 5,552.9	\$ 5,667.2	\$ 5,284.2	\$ 4,654.5
PRINCIPAL LIFE STATUTORY DATA:(3)							
Premiums and deposits(4).....	\$ 2,301.9	\$ 7,665.5	\$15,653.3	\$15,709.8	\$14,120.3	\$12,710.9	\$12,156.2
Net income(5).....	125.2	355.1	912.6	713.7	511.4	432.2	415.0
Statutory capital and surplus(6)....							
Statutory capital and surplus(6)....	\$ 3,328.9	\$ 3,095.4	\$ 3,356.4	\$ 3,151.9	\$ 3,031.5	\$ 2,811.1	\$ 2,503.5
Asset valuation reserve.....	878.0	951.2	919.8	953.8	966.9	1,087.9	1,005.0
Statutory capital and surplus and asset valuation reserve.....	\$ 4,206.9	\$ 4,046.6	\$ 4,276.2	\$ 4,105.7	\$ 3,998.4	\$ 3,899.0	\$ 3,508.5
OTHER SUPPLEMENTAL DATA:							
Net income.....	\$ 224.4	\$ 245.3	\$ 620.2	\$ 742.1	\$ 693.0	\$ 453.5	\$ 526.0
Less:							
Net realized capital gains (losses), as adjusted(7).....	(108.2)	23.1	93.1	266.9	320.7	111.4	261.0
Non-recurring items(8).....	(31.4)	(75.8)	(101.0)	--	104.8	--	--
Operating earnings.....	\$ 364.0	\$ 298.0	\$ 628.1	\$ 475.2	\$ 267.5	\$ 342.1	\$ 265.0
Operating return on average							
equity(9).....	11.1%	8.3%	10.5%	8.9%	5.8%	8.5%	7.5%
Total return on average							
equity(10).....	9.6%	8.4%	10.3%	13.9%	15.1%	11.3%	14.9%
Operating earnings before amortization of goodwill and other intangibles.....							
Operating earnings before amortization of goodwill and other intangibles.....	\$ 385.6	\$ 317.9	\$ 670.8	\$ 492.0	\$ 304.0	\$ 352.0	\$ 273.7
Assets under management (\$ in billions).....							
Assets under management (\$ in billions).....	\$ 116.9	\$ 117.1	\$ 117.5	\$ 116.6	\$ 80.4	\$ 72.1	\$ 63.0
Number of employees (actual).....							
Number of employees (actual).....	17,646	16,999	17,473	17,129	15,970	17,637	17,010

We evaluate segment performance by segment operating earnings, which excludes the effect of net realized capital gains and losses, as adjusted, and non-recurring events and transactions. We determine segment operating earnings by adjusting GAAP net income for net realized capital gains and losses, as adjusted, and non-recurring items that we believe are not indicative of overall operating trends. While these items may be significant components in understanding and assessing our consolidated financial performance, we believe the presentation of segment operating earnings enhances the understanding of our results of operations by highlighting earnings attributable to the normal, recurring operations of our businesses. However, segment operating earnings are not a substitute for net income determined in accordance with GAAP.

The following table provides selected segment information as of or for the six months ended June 30, 2001 and 2000, and as of or for each of the years ended December 31, 2000, 1999 and 1998. The segment information is reported on a consolidated basis.

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,				AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001(2)		2000(2)		2000(2)		1999(2)
	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL	AMOUNT
	(\$ IN MILLIONS)						
<b>OPERATING EARNINGS DATA:</b>							
Operating revenues:							
U.S. Asset Management and Accumulation(11).....	\$ 1,858.2	43%	\$ 1,700.7	39%	\$ 3,533.9	40%	\$ 3,472.6
International Asset Management and Accumulation.....	310.1	7	309.5	7	630.7	7	379.6
Life and Health Insurance.....	1,978.2	46	2,100.7	48	4,122.6	46	3,985.5
Mortgage Banking.....	293.1	7	180.7	4	359.8	4	398.3
Corporate and Other(11)(12).....	57.5	1	40.5	1	97.1	1	61.9
Total operating revenues.....	4,497.1	104	4,332.1	99	8,744.1	98	8,297.9
Net realized capital gains (losses), including recognition of front-end fee revenues(7).....	(176.4)	(4)	33.4	1	140.8	2	403.5
Total consolidated revenues.....	\$ 4,320.7	100%	\$ 4,365.5	100%	\$ 8,884.9	100%	\$ 8,701.4
Operating earnings (loss):							
U.S. Asset Management and Accumulation.....	\$ 176.9	48%	\$ 177.3	59%	\$ 356.6	57%	\$ 356.6
International Asset Management and Accumulation.....	(4.7)	(1)	(3.7)	(1)	(8.5)	(1)	(38.4)
Life and Health Insurance.....	90.9	25	86.0	29	162.3	26	90.7
Mortgage Banking.....	68.8	19	34.4	12	50.0	8	56.8
Corporate and Other.....	32.1	9	4.0	1	67.7	10	9.5
Total operating earnings.....	\$ 364.0	100%	\$ 298.0	100%	\$ 628.1	100%	\$ 475.2
<b>INCOME STATEMENT DATA:</b>							
Net income (loss):							
U.S. Asset Management and Accumulation.....	\$ 125.3	56%	\$ 142.2	58%	\$ 320.7	52%	\$ 321.2
International Asset Management and Accumulation.....	(25.9)	(12)	(0.2)	--	(7.1)	(1)	(30.7)
Life and Health Insurance.....	86.3	38	136.1	55	209.6	34	100.8
Mortgage Banking.....	68.8	31	34.4	14	50.0	8	56.8
Corporate and Other.....	(30.1)	(13)	(67.2)	(27)	47.0	7	294.0
Total net income.....	\$ 224.4	100%	\$ 245.3	100%	\$ 620.2	100%	\$ 742.1
<b>BALANCE SHEET DATA:</b>							
Total assets:							
U.S. Asset Management and Accumulation.....	\$66,182.4	78%	\$65,109.4	77%	\$65,795.9	78%	\$65,096.4
International Asset Management and Accumulation.....	4,919.6	6	5,547.3	7	5,525.9	7	5,926.8
Life and Health Insurance.....	10,637.2	12	10,293.8	12	10,569.0	12	10,070.8
Mortgage Banking.....	2,168.9	3	1,606.3	2	1,556.3	2	1,737.7
Corporate and Other(13).....	1,321.6	1	1,789.5	2	957.8	1	1,121.5
Total assets.....	\$85,229.7	100%	\$84,346.3	100%	\$84,404.9	100%	\$83,953.2

AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
1999(2)	1998(2)	
% OF TOTAL	AMOUNT	% OF TOTAL
(\$ IN MILLIONS)		

**OPERATING EARNINGS DATA:**  
Operating revenues:  
U.S. Asset Management and



Accumulation(11).....	40%	\$ 2,933.1	36%
International Asset Management and Accumulation.....	4	223.1	3
Life and Health Insurance.....	46	3,893.1	47
Mortgage Banking.....	4	340.6	4
Corporate and Other(11)(12).....	1	342.5	4
	---	-----	---
Total operating revenues.....	95	7,732.4	94
Net realized capital gains (losses), including recognition of front-end fee revenues(7).....	5	464.5	6
	---	-----	---
Total consolidated revenues.....	100%	\$ 8,196.9	100%
	===	=====	===

Operating earnings (loss):			
U.S. Asset Management and Accumulation.....	75%	\$ 238.4	89%
International Asset Management and Accumulation.....	(8)	(35.4)	(13)
Life and Health Insurance.....	19	50.0	19
Mortgage Banking.....	12	58.8	22
Corporate and Other.....	2	(44.3)	(17)
	---	-----	---
Total operating earnings.....	100%	\$ 267.5	100%
	===	=====	===

INCOME STATEMENT DATA:

Net income (loss):			
U.S. Asset Management and Accumulation.....	43%	\$ 277.0	40%
International Asset Management and Accumulation.....	(4)	(10.1)	(1)
Life and Health Insurance.....	13	112.0	16
Mortgage Banking.....	8	58.8	8
Corporate and Other.....	40	255.3	37
	---	-----	---
Total net income.....	100%	\$ 693.0	100%
	===	=====	===

BALANCE SHEET DATA:

Total assets:			
U.S. Asset Management and Accumulation.....	78%	\$58,701.5	79%
International Asset Management and Accumulation.....	7	1,239.4	2
Life and Health Insurance.....	12	9,219.5	13
Mortgage Banking.....	2	1,810.4	2
Corporate and Other(13).....	1	3,075.9	4
	---	-----	---
Total assets.....	100%	\$74,046.7	100%
	===	=====	===

	AS OF JUNE 30,				AS OF DECEMBER 31,			
	2001(2)		2000(2)		2000(2)		1999(2)	
	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL	AMOUNT	
	(\$ IN BILLIONS)							
OTHER SUPPLEMENTAL DATA:								
Assets Under Management: (\$ in billions)								
U.S. Asset Management and Accumulation.....	\$ 78.7	68%	\$ 73.9	63%	\$ 78.1	67%	\$ 75.6	
International Asset Management and Accumulation.....	25.7	22	29.7	26	28.4	24	30.6	
Life and Health Insurance.....	9.5	8	9.2	8	9.3	8	8.7	
Mortgage Banking(14).....	0.3	--	1.6	1	0.2	--	0.5	
Corporate and Other.....	2.7	2	2.7	2	1.5	1	1.2	
Total assets under management.....	\$ 116.9	100%	\$ 117.1	100%	\$ 117.5	100%	\$ 116.6	

AS OF DECEMBER 31,		
1999(2)	1998(2)	
% OF TOTAL	AMOUNT	% OF TOTAL
(\$ IN BILLIONS)		

OTHER SUPPLEMENTAL DATA:			
Assets Under Management: (\$ in billions)			
U.S. Asset Management and Accumulation.....	65%	\$ 67.2	84%
International Asset Management and Accumulation.....	26	1.2	1
Life and Health Insurance.....	8	8.2	10
Mortgage Banking(14).....	--	0.7	1
Corporate and Other.....	1	3.1	4
Total assets under management.....	100%	\$ 80.4	100%

(1) We have reclassified periods prior to June 30, 2001, to conform to the presentation for that period.

(2) Our consolidated financial results were affected by the following transactions that affect year-to-year comparability:

- On September 25, 2001, we disposed of all the stock of PT Asuransi Jiwa Principal Indonesia, our subsidiary in Indonesia. We currently have no business operations in Indonesia. Total assets of our operations in Indonesia as of June 30, 2001 were \$3.4 million. We included nominal revenues and net loss from our operations in Indonesia in our consolidated results of operations for the six months ended June 30, 2001 and 2000, and for the years ended December 31, 2000, 1999 and 1998.

- On February 15, 2001, we disposed of all of the stock of Principal International Espana, S.A. de Seguros de Vida, our subsidiary in Spain, for nominal proceeds, resulting in a net realized capital loss of \$38.4 million, ceasing our business operations in Spain. Total assets of our operations in Spain as of December 31, 2000 were \$222.7 million. We included revenues of \$33.1 million from our operations in Spain in our consolidated results of operations for the six months ended June 30, 2000, and revenues of \$49.4 million, \$51.7 million and \$46.0 million in our results of operations for the years ended December 31, 2000, 1999 and 1998, respectively. We included net income of \$2.2 million from our operations in Spain for the six months ended June 30, 2000, and a net loss of \$1.2 million and net income of \$0.9 million and \$2.8 million in our results of operations for the years ended December 31, 2000, 1999 and 1998, respectively. We did not include revenues or net income from our operations in Spain in our consolidated results of operations for the six months ended June 30, 2001.

- On August 31, 1999, we acquired several companies affiliated with Bankers Trust Australia Group from Deutsche Bank AG at a purchase price of \$1.4 billion. The acquired companies now operate under the name BT Financial Group. We accounted for the acquisition using the purchase method. We included the results of operations of the acquired companies in our International Asset Management and Accumulation segment and our consolidated financial statements from the date of acquisition. We included revenues of \$122.5 million and net loss of \$5.8 million in our consolidated results of operations for the six months ended June 30, 2001. We included revenues of \$145.4 million and net income of \$6.2 million in our consolidated results of operations for the six months ended June 30, 2000. We included revenues of \$285.5 million and net income of \$6.5 million in our consolidated results of operations for the year ended December 31, 2000. We included revenues of \$116.5 million and net loss of \$3.1 million in our consolidated results of operations for the year ended December 31, 1999. We accounted for the purchase price as

follows: \$897.4 million of identifiable intangibles, consisting primarily of management rights and the BT brand name, \$38.5 million of workforce intangibles and \$408.6 million of resulting goodwill, which are being amortized on a straight line basis over 40 years, 8 years and 25 years, respectively.

- We acquired Compania de Seguros de Vida El Roble S.A., or El Roble, a Chilean life insurance company, for a purchase price of \$73.4 million in July 1998. We included El Roble's financial results in our International Asset Management and Accumulation segment. We combined the operations of our existing Chilean life insurance affiliate with the operations of El Roble to form Principal International de Chile. Our consolidated financial results related to these companies' combined operations include: total revenues of \$108.6 million and \$95.7 million for the six months ended June 30, 2001 and 2000, respectively, and \$200.2 million, \$178.1 million and \$155.2 million for the years ended December 31, 2000, 1999 and 1998, respectively; and net income of \$4.3 million and \$3.4 million for the six months ended June 30, 2001 and 2000, respectively, and \$10.2 million, \$0.5 million and \$17.0 million for the years ended December 31, 2000, 1999 and 1998, respectively.
- In July 1998, we established our residential mortgage loan wholesale distribution system, a new distribution channel, by acquiring ReliaStar Mortgage Corporation for a purchase price of \$18.6 million. We have integrated the operations of ReliaStar Mortgage Corporation into Principal Residential Mortgage, Inc., as part of our Mortgage Banking segment.

- Effective April 1, 1998, we transferred substantially all of our health maintenance organization operations, or HMO operations, to Coventry Health Care, Inc., or Coventry, in exchange for 42% of their common stock. Our net equity in the transferred HMO operations had a carrying value of \$170.0 million on April 1, 1998. We sold our remaining HMO operations in 1998 for \$20.5 million resulting in no realized capital gain or loss. Prior to the transfer to Coventry, our Corporate and Other segment included \$266.7 million of HMO revenues in our results for 1998. We report our investment in Coventry in our Corporate and Other segment and account for it using the equity method. Our share of Coventry's net income was \$9.7 million and \$10.8 million for the six months ended June 30, 2001 and 2000, respectively, and \$20.0 million and \$19.1 million for the years ended December 31, 2000 and 1999, respectively. Our share of Coventry's net loss was \$9.8 million for the year ended December 31, 1998. In September 2000, we sold a portion of our Coventry stock, which reduced our ownership interest to approximately 25% of Coventry stock and resulted in a net realized capital gain of \$13.9 million, net of tax. Our carrying amount in Coventry was \$134.6 million as of June 30, 2001.
- (3) We have provided statutory data from quarterly and annual statements of Principal Life filed with insurance regulatory authorities. Certain financial information for periods beginning on or after January 1, 2001 is not comparable to information from earlier periods. We prepared statutory data as of or for the six months ended June 30, 2001 in conformity with the NAIC Codification of Statutory Principles ("Codification"), adopted as prescribed and permitted by the Insurance Division, Department of Commerce of the State of Iowa, effective January 1, 2001. As allowed by Codification, we did not restate prior period information. We prepared statutory data as of or for the six months ended June 30, 2000 and the years ended December 31, 2000, 1999, 1998, 1997 and 1996 in conformity with accounting practices prescribed or permitted on the dates thereof by the Insurance Division, Department of Commerce of the State of Iowa.
- (4) Codification, as adopted by Principal Life on January 1, 2001, has significantly impacted the reporting of Principal Life's statutory premiums and deposits for the six months ended June 30, 2001. Under Codification, we no longer report amounts received for deposit-type contracts in the statement of operations as revenue, but rather report these amounts directly as an increase in an appropriate policy reserve account, a treatment that is similar to that under U.S. GAAP. This has the effect of decreasing reported total revenues and total expenses of Principal Life, with no effect to statutory net income or statutory surplus. Premiums and deposits for the six months ended June 30, 2000 and for the years ended December 31, 2000, 1999, 1998, 1997 and 1996 included amounts received for deposit-type contracts of \$5,432.8 million, \$11,273.2 million, \$11,571.5 million, \$10,312.6 million, \$8,694.9 million and \$7,493.9 million, respectively.
- (5) Codification, as adopted by Principal Life on January 1, 2001, has impacted the reporting of Principal Life's statutory net income for the six months ended June 30, 2001. Under Codification our net income has been significantly impacted due to a change in the accounting for undistributed income (loss) from subsidiaries. We no longer report undistributed income (loss) from subsidiaries as part of net investment income, but rather report these amounts as unrealized gains and losses, which are excluded from the calculation of net income. This has the effect of decreasing reported total statutory revenues and net income, but has no effect on statutory surplus. Undistributed income from subsidiaries for the six months ended June 30, 2000, and for the years ended December 31, 2000 and 1999 were \$100.0 million, \$208.9 million and \$159.9 million, respectively, and undistributed loss from subsidiaries for the years ended December 31, 1998, 1997 and 1996 were \$0.4 million, \$41.3 million and \$104.1 million, respectively.
- (6) On August 24, 2001, Principal Life paid a statutory dividend of \$250.0 million, which reduced its surplus by that amount.

(7) Net realized capital gains (losses), as adjusted, are net of tax, related changes in the amortization pattern of deferred policy acquisition costs, recognition of front-end fee revenues for sales charges on pension products and services and net realized capital gains credited to customers. This presentation may not be comparable to presentations made by other companies. Deferred policy acquisition costs represent commissions and other selling expenses that vary with and are directly related to the production of business. These acquisition costs are deferred and amortized in conformity with GAAP.

Following is a reconciliation of net realized capital gains (losses) from the consolidated financial statements and the adjustment made to calculate segment operating earnings for the periods indicated:

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,				
	2001	2000	2000	1999	1998	1997	1996
	(\$ IN MILLIONS)						
Net realized capital gains (losses)....	\$ (176.9)	\$ 31.5	\$ 139.9	\$ 404.5	\$ 465.8	\$ 175.3	\$ 387.8
Recognition of front-end fee revenues.....	0.5	1.9	0.9	(1.0)	(1.3)	(0.9)	--
Net realized capital gains (losses), including recognition of front-end fee revenues.....	(176.4)	33.4	140.8	403.5	464.5	174.4	387.8
Amortization of deferred policy acquisition costs related to net realized capital gains (losses)....	3.9	(3.4)	(0.3)	4.4	5.7	(1.7)	--
Amounts credited to contractholder accounts.....	--	--	--	--	(26.3)	--	--
Non-recurring net realized capital losses.....	--	--	--	--	(1.7)	--	--
Net realized capital gains (losses), including recognition of front-end fee revenues, net of related amortization of deferred policy acquisition costs and amounts credited to contractholders.....	(172.5)	30.0	140.5	407.9	442.2	172.7	387.8
Income tax effect.....	64.3	(6.9)	(47.4)	(141.0)	(121.5)	(61.3)	(126.8)
Net realized capital gains (losses), as adjusted.....	<u>\$ (108.2)</u>	<u>\$ 23.1</u>	<u>\$ 93.1</u>	<u>\$ 266.9</u>	<u>\$ 320.7</u>	<u>\$ 111.4</u>	<u>\$ 261.0</u>

(8) For the six months ended June 30, 2001, we excluded \$31.4 million of non-recurring items, net of tax, from net income for the presentation of operating earnings. The non-recurring items included the negative effects of: (a) expenses related to our demutualization (\$14.8 million); (b) a cumulative effect of change in accounting principle related to our implementation of SFAS 133 (\$10.7 million), as discussed in Note 2 to Principal Mutual Holding Company's unaudited consolidated financial statements; and (c) a loss contingency reserve established for sales practices litigation (\$5.9 million).

For the six months ended June 30, 2000, we excluded \$75.8 million of non-recurring items, net of tax, from net income for our presentation of consolidated operating earnings. The non-recurring items included the negative effects of: (a) a loss contingency reserve established for sales practices litigation (\$75.0 million), and (b) expenses related to our demutualization (\$0.8 million).

For the year ended December 31, 2000, we excluded \$101.0 million of non-recurring items, net of tax, from net income for our presentation of operating earnings. The non-recurring items included the negative effects of: (a) a loss contingency reserve established for sales practices litigation (\$93.8 million) and (b) expenses related to our demutualization (\$7.2 million).

For the year ended December 31, 1998, we excluded \$104.8 million of non-recurring items, net of tax, from net income for our presentation of operating earnings. The non-recurring items included:

- the positive effects of (a) Principal Life's release of tax reserves and related accrued interest (\$164.4 million) and (b) accounting changes by our international operations (\$13.3 million); and
- the negative effects of (a) expenses and adjustments for changes in amortization assumptions for deferred policy acquisition costs related to our corporate structure change to a mutual insurance holding company

(\$27.4 million) and (b) a contribution related to permanent endowment of the Principal Financial Group Foundation (\$45.5 million).

- (9) We define operating return on average equity as operating earnings divided by average total equity, excluding accumulated other comprehensive income. We calculate the returns for interim reporting periods by using operating earnings for the trailing twelve months. We have excluded accumulated other comprehensive income due to its volatility between periods and because such data are often excluded when evaluating the overall financial performance of insurers. Operating return on average equity should not be considered a substitute for any GAAP measure of performance.
- (10) We define total return on average equity as net income divided by average total equity, excluding accumulated other comprehensive income. We calculate the returns for interim reporting periods by using net income for the trailing twelve months. We have excluded accumulated other comprehensive income due to its volatility between periods and because such data are often excluded when evaluating the overall financial performance of insurers.
- (11) We transferred our U.S. investment management operations from our Corporate and Other segment to our U.S. Asset Management and Accumulation segment effective January 1, 1999. The U.S. Asset Management and Accumulation segment received fee revenues for performing investment management services for other segments in 2001, 2000 and 1999. The Corporate and Other segment received fee revenues for performing investment management services for other segments prior to 1999.
- (12) Includes inter-segment eliminations primarily related to real estate joint venture rental income. We reported rental income from real estate joint ventures for office space used by other segments in the Corporate and Other segment.
- (13) Includes inter-segment elimination amounts related to internally generated mortgage loans and an internal line of credit. The U.S. Asset Management and Accumulation segment and Life and Health Insurance segment reported mortgage loan assets issued for real estate joint ventures. These mortgage loans were reported as liabilities in the Corporate and Other segment. In addition, the Corporate and Other segment managed a revolving line of credit used by other segments.
- (14) Excludes our mortgage loan servicing portfolio.

UNAUDITED PRO FORMA CONDENSED CONSOLIDATED FINANCIAL INFORMATION

The unaudited pro forma condensed consolidated financial information presented below for Principal Financial Group, Inc. gives effect to:

- the demutualization;
- the sale of shares of common stock in this offering; and
- the application of the net proceeds from this offering as described in "Use of Proceeds," as if the demutualization and the initial public offering had occurred as of June 30, 2001, for purposes of the unaudited pro forma condensed consolidated statement of financial position, and as of January 1, 2000, for purposes of the unaudited pro forma condensed consolidated statement of operations for the six months ended June 30, 2001, and the year ended December 31, 2000.

The principal assumptions used in the pro forma information are as follows:

- 100.0 million shares of common stock are sold to investors in the offering at a price of \$18.50 per share;
- 260.6 million shares of common stock are allocated and issued to policyholders entitled to receive compensation in the demutualization, of which 56.2 million shares are allocated and issued as part of the Separate Account Policy Credits;
- 89.4 million shares of common stock are allocated but not issued to policyholders entitled to receive compensation in the demutualization who receive payments in the form of cash or policy credits (excluding Separate Account Policy Credits) at an initial public offering price of \$18.50 per share, rather than in shares of common stock; and
- a federal income tax rate of 35% is used to show the income tax effects of the pro forma adjustments.

The pro forma information reflects gross proceeds of \$1,850.0 million from the issuance of the shares, less the underwriting discount and offering expenses aggregating \$96.7 million, or net proceeds from the offering of \$1,753.3 million. Of the net proceeds, we have assumed that Principal Financial Group, Inc. was entitled to and did retain \$59.5 million to be used for working capital, payment of a dividend, if any, to our stockholders in the first year after the date of the closing of this offering and other general corporate purposes, and the remaining \$1,693.8 million will be contributed to Principal Life. For purposes of the pro forma statement of financial position, we have estimated that \$5.8 million pre-tax will be required for the cost of additional nonrecurring expenses related to the demutualization, \$1,329.5 million will be used to make elective cash payments and fund Account Value Policy Credits to policyholders receiving these forms of compensation in the demutualization and \$324.7 million will be used to provide compensation to policyholders eligible solely for cash or policy credits.

The pro forma information is based on available information and on assumptions management believes are reasonable. The pro forma information is provided for informational purposes only. This information does not necessarily indicate our consolidated financial position or our consolidated results of operations had these transactions been consummated on the dates assumed. It also does not in any way represent a projection or forecast of our consolidated financial position or consolidated results of operations for any future date or period.

The pro forma information should be read in conjunction with our consolidated financial statements and the notes to the financial statements, included in this prospectus, and with the other information included in this prospectus, including the information provided under "The Demutualization," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business".

UNAUDITED PRO FORMA CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION

AS OF JUNE 30, 2001

	HISTORICAL	THE DEMUTUALIZATION	THE INITIAL PUBLIC OFFERING	PRO FORMA
	(\$ IN MILLIONS)			
<b>ASSETS</b>				
Invested assets:				
Fixed maturities, available-for-sale.....	\$29,328.2	\$ --	\$ --	\$29,328.2
Equity securities, available-for-sale.....	578.8	--	--	578.8
Mortgage loans.....	11,539.1	--	--	11,539.1
Real estate.....	1,238.3	--	--	1,238.3
Policy loans.....	820.1	--	--	820.1
Other investments.....	898.7	--	--	898.7
Total invested assets.....	44,403.2	--	--	44,403.2
Cash and cash equivalents.....	371.9	(1,181.5)(1)	1,753.3(2)	940.0
		(3.7)(5)		
Accrued investment income.....	577.9	--	--	577.9
Premiums due and other receivables.....	572.3	--	--	572.3
Deferred policy acquisition costs.....	1,338.3	--	--	1,338.3
Property and equipment.....	513.4	--	--	513.4
Goodwill and other intangibles.....	1,252.9	--	--	1,252.9
Mortgage loan servicing rights.....	1,487.2	--	--	1,487.2
Separate account assets.....	33,739.5	1,039.7(7)	--	34,779.2
Other assets.....	973.1	--	--	973.1
Total assets.....	\$85,229.7	\$ (145.5)	\$1,753.3	\$86,837.5
	=====	=====	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
Liabilities:				
Contractholder funds.....	\$25,073.1	\$ --	\$ --	\$25,073.1
Future policy benefits and claims.....	13,494.8	472.7(1)	--	13,967.5
Other policyholder funds.....	591.5	--	--	591.5
Short-term debt.....	675.9	--	--	675.9
Long-term debt.....	1,390.6	--	--	1,390.6
Income taxes currently payable.....	3.6	--	--	3.6
Deferred income taxes.....	740.1	--	--	740.1
Separate account liabilities.....	33,739.5	1,039.7(7)	--	34,779.2
Other liabilities.....	2,992.2	--	--	2,992.2
Total liabilities.....	78,701.3	1,512.4	--	80,213.7
Stockholders' equity:				
Common stock, \$0.01 par value; 2.5 billion shares authorized; 360.6 million shares issued and outstanding(6).....	--	2.6(3)	1.0(2)	3.6
Additional paid-in capital.....	--	4,876.4(3)	1,752.3(2)	6,628.7
Retained earnings.....	6,536.9	(1,654.2)(1)	--	--
		(4,879.0)(3)		
		(3.7)(5)		
Accumulated other comprehensive loss.....	(8.5)	--	--	(8.5)
Total stockholders' equity.....	6,528.4	(1,657.9)	1,753.3	6,623.8
Total liabilities and stockholders' equity.....	\$85,229.7	\$ (145.5)	\$1,753.3	\$86,837.5
	=====	=====	=====	=====

See notes to unaudited pro forma condensed consolidated financial information.



UNAUDITED PRO FORMA CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

FOR THE SIX MONTHS ENDED JUNE 30, 2001

	HISTORICAL	THE DEMUTUALIZATION	THE INITIAL PUBLIC OFFERING	PRO FORMA
	(\$ AND SHARES IN MILLIONS, EXCEPT PER SHARE AMOUNTS)			
<b>Revenues:</b>				
Premiums and other considerations.....	\$1,955.3	\$ --	\$ --	\$1,955.3
Fees and other revenues.....	856.3	--	--	856.3
Net investment income.....	1,686.0	--	--	1,686.0
Net realized capital losses.....	(176.9)	--	--	(176.9)
Total revenues.....	4,320.7	--	--	4,320.7
<b>Expenses:</b>				
Benefits, claims and settlement expenses.....	2,639.2	--	--	2,639.2
Dividends to policyholders.....	162.1	--	--	162.1
Operating expenses.....	1,228.2	(22.7)(4)	--	1,205.5
Total expenses.....	4,029.5	(22.7)	--	4,006.8
Income before income taxes and cumulative effect of accounting change.....	291.2	22.7	--	313.9
Income taxes.....	56.1	7.9	--	64.0
Income before cumulative effect of accounting change.....	235.1	14.8	--	249.9
Cumulative effect of accounting change, net of related income taxes.....	(10.7)	--	--	(10.7)
Net income.....	\$ 224.4	\$14.8	\$ --	\$ 239.2
Income per share.....				\$ 0.66
Shares used in calculating per share amount(6).....				360.6

UNAUDITED PRO FORMA CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

FOR THE YEAR ENDED DECEMBER 31, 2000

	HISTORICAL	THE DEMUTUALIZATION	THE INITIAL PUBLIC OFFERING	PRO FORMA
	(\$ AND SHARES IN MILLIONS, EXCEPT PER SHARE AMOUNTS)			
<b>Revenues:</b>				
Premiums and other considerations.....	\$3,996.4	\$ --	\$ --	\$3,996.4
Fees and other revenues.....	1,576.3	--	--	1,576.3
Net investment income.....	3,172.3	--	--	3,172.3
Net realized capital gains.....	139.9	--	--	139.9
Total revenues.....	8,884.9	--	--	8,884.9
<b>Expenses:</b>				
Benefits, claims and settlement expenses.....	5,232.3	--	--	5,232.3
Dividends to policyholders.....	312.7	--	--	312.7
Operating expenses.....	2,479.4	(11.1)(4)	--	2,468.3
Total expenses.....	8,024.4	(11.1)	--	8,013.3
Income before income taxes.....	860.5	11.1	--	871.6
Income taxes.....	240.3	3.9	--	244.2
Net income.....	\$ 620.2	\$ 7.2	\$ --	\$ 627.4
Income per share.....				\$ 1.74
Shares used in calculating per share amount(6).....				360.6

See notes to unaudited pro forma condensed consolidated financial information.

NOTES TO UNAUDITED PRO FORMA CONDENSED CONSOLIDATED FINANCIAL INFORMATION

(1) Represents (\$ in millions):

Cash assumed to be distributed to policyholders who elected cash and to policyholders eligible solely for cash.....	\$1,181.5
Policy credits assumed to be distributed to policyholders eligible solely for policy credits and Account Value Policy Credits assumed to be distributed to policyholders who have elected or have been deemed to have elected Account Value Policy Credits.....	472.7
	-----
Total.....	\$1,654.2
	=====

- (2) Represents gross proceeds of \$1,850.0 million from the sale of 100.0 million shares of common stock at an initial public offering price of \$18.50 per share, less estimated underwriting discounts and offering expenses of \$96.7 million.
- (3) Represents the reclassification of the residual retained earnings (\$4,879.0 million) of Principal Mutual Holding Company to common stock (\$2.6 million) and additional paid-in capital (\$4,876.4 million) to reflect the demutualization.
- (4) Represents the elimination of \$22.7 million, or \$14.8 million net of tax, of expenses related to the demutualization incurred through the six months ended June 30, 2001, and \$11.1 million, or \$7.2 million net of tax, of expenses related to the demutualization incurred through December 31, 2000.
- (5) The estimated additional non-recurring expenses of \$5.8 million, or \$3.7 million net of tax, related to the demutualization, assumed to be incurred as of the date of the unaudited pro forma condensed consolidated statement of financial condition, were charged to equity. The pro forma condensed consolidated statement of operations does not reflect such non-recurring expenses.
- (6) The assumed number of shares used in the calculation of unaudited pro forma net income per common share was determined as follows:

	NUMBER OF SHARES (IN MILLIONS)
	-----
Assumed shares allocated to eligible policyholders.....	350.0
Less: assumed shares allocated to eligible policyholders who receive cash or policy credits (excluding Separate Account Policy Credits)(a).....	89.4
	-----
Assumed shares issued to eligible policyholders(b).....	260.6
Shares issued in this offering.....	100.0
	-----
Total outstanding shares of common stock.....	360.6
	=====

(a) Gives effect to (1) \$1,329.5 million to make elective cash payments and fund Account Value Policy Credits to eligible policyholders receiving these forms of compensation and (2) \$324.7 million to provide compensation to policyholders eligible solely for cash or policy credits.

(b) Includes 56.2 million shares issued as part of the Separate Account Policy Credits. These shares are included in both basic and diluted income per share calculations.

The plan of conversion provides that the amount of consideration paid in cash or provided as policy credits to an eligible policyholder will equal the number of shares allocated to such eligible policyholder multiplied by the initial public offering price.

- (7) Represents the value of 56.2 million shares placed in the separate account for Qualified Plan Customers at a share price of \$18.50 per share. The valuations of the separate account shares are recorded at fair value and are reported as separate account assets and separate account liabilities in the unaudited pro forma condensed consolidated statement of financial position. Changes in the fair value of the separate account shares are reflected in both the separate account assets and separate account liabilities and do not impact the pro forma results of operations.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following analysis of the consolidated results of our operations and financial condition should be read in conjunction with the "Selected Historical Financial Information," the consolidated financial statements and the related notes to the financial statements and the other financial information included elsewhere in this prospectus.

FORWARD-LOOKING INFORMATION

Our narrative analysis below and in "Business" contains forward-looking statements that are intended to enhance the reader's ability to assess our future financial performance. Forward-looking statements include, but are not limited to, statements that represent our beliefs concerning future operations, strategies, financial results or other developments, and contain words and phrases such as "may," "expects," "should" or similar expressions. Because these forward-looking statements are based on estimates and assumptions that are subject to significant business, economic and competitive risks and uncertainties, many of which are beyond our control or are subject to change, actual results could be materially different. See "Risk Factors" for a discussion of risks and uncertainties that may cause our actual results to differ materially.

OVERVIEW

We are a leading provider of retirement savings, investment and insurance products and services. We have four operating segments:

- U.S. Asset Management and Accumulation, which consists of our asset accumulation operations which provide products and services, including retirement savings and related investment products and services, and our asset management operations conducted through Principal Capital Management, our U.S.-based asset manager. We provide a comprehensive portfolio of asset accumulation products and services to businesses and individuals in the United States, with a concentration on small and medium-sized businesses, which we define as businesses with fewer than 1,000 employees. We offer to businesses products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans and non-qualified executive benefit plans. We also offer annuities, mutual funds and bank products and services to the employees of our business customers and other individuals.
- International Asset Management and Accumulation, which consists of BT Financial Group, our Australia-based asset manager, and Principal International. Our acquisition of BT Financial Group in 1999 was a central element in the expansion of our international asset management and accumulation businesses. Through Principal International, we offer retirement products and services, annuities, mutual funds and life insurance. We operate through subsidiaries in Argentina, Chile, Mexico and Hong Kong and joint ventures in Brazil, Japan and India.
- Life and Health Insurance, which provides individual life and disability insurance as well as group life and health insurance throughout the United States. Our individual insurance products include interest-sensitive life, traditional life and disability insurance. Our group insurance products include life, disability, medical, dental and vision insurance, and administrative services.
- Mortgage Banking, which engages in originating, purchasing, selling and servicing residential mortgage loans in the United States.

We also have a Corporate and Other segment which consists of the assets and activities that have not been allocated to any other segment.

REVENUES AND EXPENSES

Our segments earn revenues and incur expenses from various sources as outlined in the following tables. The following tables provide a detailed list of the sources and their relationship to our financial statement line items.

REVENUES. The table below provides a summary of our sources of revenues by segment:

REVENUE SOURCES BY SEGMENT

REVENUE SOURCES	U.S. ASSET MANAGEMENT AND ACCUMULATION	INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION	LIFE AND HEALTH INSURANCE	MORTGAGE BANKING	CORPORATE AND OTHER
<b>PREMIUMS AND OTHER CONSIDERATIONS:</b>					
Single premium group and individual annuities with life contingencies	X	X			
Group and individual life insurance		X	X		
Group medical, dental and vision insurance			X		
Group and individual disability insurance			X		
<b>FEES AND OTHER REVENUES:</b>					
Administrative and asset management fee revenues from group and individual variable annuities	X	X			
Administrative fee revenues from pension plans	X	X			
Asset management and administrative fee revenues from institutional asset management and mutual funds	X	X			
Assets backing margin lending operations		X			
Mortality, administrative and asset management fee revenues from variable and universal life insurance products		X	X		
Group fee-for-service business			X		
Servicing and originating residential mortgage loans		X		X	
Net gains and losses on the sale of residential mortgage loans and residential mortgage loan servicing rights				X	
Fee revenues from the marketing of other products to our servicing portfolio customers				X	
<b>NET INVESTMENT INCOME:</b>					
Securitizations of commercial mortgage-backed securities	X				
Assets backing group guaranteed investment contracts and individual fixed annuities	X	X			
Assets backing life and health insurance product liabilities		X	X		
Securitizations of residential mortgage loans				X	
Assets backing capital	X	X	X	X	X

EXPENSES. The table below provides a summary of our expenses by segment:

EXPENSES BY SEGMENT

EXPENSES	U.S. ASSET MANAGEMENT AND ACCUMULATION	INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION	LIFE AND HEALTH INSURANCE	MORTGAGE BANKING	CORPORATE AND OTHER
<b>BENEFITS, CLAIMS AND SETTLEMENT EXPENSES:</b>					
Benefits paid and reserve increases on single premium group and individual annuities with life contingencies	X	X			
Interest credited on group guaranteed investment contracts and individual fixed annuities	X	X			
Benefits paid and reserve increases on group and individual life insurance		X	X		
Benefits paid and reserve increases on group medical, dental and vision insurance			X		
Benefits paid and reserve increases on group and individual disability insurance			X		
DIVIDENDS TO POLICYHOLDERS	X		X		
<b>OPERATING EXPENSES:</b>					
General business expenses and commissions, net of deferred expenses	X	X	X	X	X
Amortization of deferred policy acquisition costs	X	X	X		
Premium taxes	X	X	X		
Income taxes	X	X	X		
Amortization of goodwill and other intangibles	X	X	X	X	X
Amortization of residential mortgage loan servicing rights		X		X	
Net gains and losses on mortgage loan servicing hedge activity				X	
Interest expense on corporate debt					X

PROFITABILITY

Our profitability depends in large part upon:

- our amount of assets under management;
- the spreads we earn on our policyholders' general account balances;
- our ability to generate fee revenues greater than the amount it costs us to administer pension products, manage investments for retail and institutional clients and provide other administrative services;
- our ability to price our life and health insurance products at a level that enables us to earn a margin over the cost of providing benefits and the expense of acquiring and administering those products, which is primarily a function of competitive conditions, persistency, our ability to assess and manage trends in mortality and morbidity experience, our ability to generate investment earnings and our ability to maintain expenses in accordance with pricing assumptions;
- our ability to effectively monitor and price residential mortgage loans we originate, purchase, and sell and to manage the costs to service residential mortgage loans;
- our ability to effectively hedge the effect of interest rate changes on our residential mortgage servicing rights. See "Business -- Mortgage Banking -- Risk Management";
- our ability to manage our investment portfolio to maximize investment returns and minimize risks such as interest rate changes or defaults or impairments of invested assets;
- fluctuations of foreign currency exchange rates; and
- our ability to manage our operating expenses.

TRENDS

U.S. ASSET MANAGEMENT AND ACCUMULATION. Our sales of pension and other asset accumulation products and services in the United States have been affected by overall trends in the U.S. retirement services industry, as our customers have begun to rely less on defined benefit retirement plans, social security and other government programs. Current trends in the work environment include a more mobile workforce and the desire of employers to pass the market risk of retirement investments to employees by shifting from offering defined benefit plans to offering defined contribution plans. These trends are increasing the demand for defined contribution pension arrangements such as 401(k) plans, as well as mutual funds and variable annuities. Also, the "baby-boom" generation of U.S. workers has reached an age where saving is critical and they continue to seek tax-advantaged investment products for retirement. Considering these trends, our group and individual variable annuity assets under management and other fee-based asset accumulation products increased through December 31, 2000, while traditional spread-based assets under management have grown at a slower rate. Fee-based assets under management decreased as of June 30, 2001, primarily due to the negative impacts of the equity markets.

The table below provides a summary of assets under management from our fee-based asset accumulation products and spread-based asset accumulation products as of June 30, 2001, and December 31, 2000, 1999, and 1998:

AS OF -----	U.S. ASSET ACCUMULATION		
	FEE-BASED ASSETS UNDER MANAGEMENT	SPREAD-BASED ASSETS UNDER MANAGEMENT	TOTAL ASSETS UNDER MANAGEMENT
	----- (\$ IN BILLIONS) -----		
June 30, 2001.....	\$41.3	\$30.6	\$71.9
December 31, 2000.....	42.5	28.5	71.0
December 31, 1999.....	42.1	28.2	70.3
December 31, 1998.....	34.5	29.0	63.5

Asset management services have been among the most profitable and rapidly growing sectors of the financial services industry, at both the retail and institutional level. We formally established Principal Capital Management, our U.S.-based asset manager, in 1999 to consolidate our investment operations and to enter the third-party institutional asset management market. We seek to take advantage of current trends which indicate that both retail and institutional investors embrace specialization, providing increased fees to successful active managers with expertise in specialty and niche areas. Our U.S. third-party assets under management were \$5.8 billion as of June 30, 2001, compared to \$3.5 billion since the establishment of Principal Capital Management on January 1, 1999.

The following table provides a summary of Principal Capital Management's affiliated and third-party assets under management as of June 30, 2001, and December 31, 2000, 1999, and 1998:

AS OF	PRINCIPAL CAPITAL MANAGEMENT		
	AFFILIATED ASSETS UNDER MANAGEMENT	THIRD-PARTY ASSETS UNDER MANAGEMENT	TOTAL ASSETS UNDER MANAGEMENT(1)
	(\$ IN BILLIONS)		
June 30, 2001.....	\$78.2	\$5.8	\$84.0
December 31, 2000.....	76.9	6.3	83.2
December 31, 1999.....	77.5	4.7	82.2
December 31, 1998(2).....	73.6	3.5	77.1

(1) Includes all assets for which Principal Capital Management provides investment advisory services.

(2) Represents assets managed by Invista Capital Management and the former investment department of Principal Life prior to the formation of Principal Capital Management, effective January 1, 1999.

**INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION.** Our international asset management and accumulation businesses focus on countries with a trend toward private sector defined contribution pension systems. Our acquisition of BT Financial Group in August 1999 is consistent with these trends. We are seeking to take advantage of an Australian government requirement for all employers to contribute 8% of an employee's salary to an employer-sponsored defined contribution retirement plan, referred to as superannuation. The required employer contribution is scheduled to rise to 9% by 2002.

The governments of other countries have also instituted privatized pension systems requiring employees who join the labor force to contribute to a private pension system. With variations depending upon the specific country, we have targeted these markets for sales of retirement and related products and services, including defined contribution pension plans, annuities and mutual funds to individuals and businesses. In several of our international markets, we complement our sales of these products with sales of life insurance products.

We have pursued our international strategy through a combination of start-ups, acquisitions and joint ventures, which require infusions of capital consistent with our strategy of long-term growth and profitability.

**LIFE AND HEALTH INSURANCE.** Our U.S. individual life insurance premiums have been influenced by both economic and industry trends. Both fee revenues and policyholder liabilities related to our interest-sensitive life insurance products have increased due to customer preference for insurance products with variable investment and tax-advantaged accumulation product options. Premiums and policyholder liabilities related to our individual traditional life insurance products have remained relatively flat.

AS OF OR FOR THE	INDIVIDUAL LIFE AND HEALTH			
	INTEREST-SENSITIVE LIFE INSURANCE		TRADITIONAL LIFE INSURANCE	
	FEE REVENUES	POLICYHOLDER LIABILITIES(1)	PREMIUMS	POLICYHOLDER LIABILITIES
	(\$ IN MILLIONS)			
Six months ended June 30, 2001.....	\$48.1	\$1,648.7	\$388.0	\$5,597.7
Year ended December 31, 2000.....	89.1	1,567.6	772.8	5,522.7
Year ended December 31, 1999.....	61.7	1,237.2	780.8	5,331.6
Year ended December 31, 1998.....	49.7	1,070.8	792.3	5,119.6

(1) Includes separate account liabilities for policies with variable insurance options.

Increased competition in the U.S. group health insurance industry has affected pricing of premiums. Most group health insurance policies are subject to annual review by policyholders, who may seek competitive quotations prior to renewal. Regulation has had and may continue to have an adverse effect on our ability to adequately price group health insurance products. At the same time, health care costs have continued to rise, placing pressure on margins. Our group health insurance premiums increased in recent years due to competitive prices and new sales initiatives. These increases were partially offset by our decisions to exit under-performing and non-strategic businesses and markets. Effective April 1, 1998, we transferred substantially all of our HMO operations to Coventry Health Care, Inc., due to unsatisfactory scale and return from these operations. Medical insurance premiums from our HMO operations were \$898.2 million in 1997. Also during 1998, we ceased sales of medical insurance products in fourteen states where we were not achieving desired returns. Medical

insurance premiums from these states were \$209.2 million in 1997. We are now focusing on sales of medical insurance products in select geographic markets where we believe we can achieve satisfactory returns. Effective January 1, 2000, we ceased new sales of our Medicare supplement insurance product and effective July 1, 2000, reinsured all existing business. We continue to sell group dental and vision insurance,



disability insurance and life insurance to employers desiring a broad range of employee benefit products and services for their employees. We have targeted these non-medical products for growth, especially dental and vision insurance products. Our group health insurance and group life insurance premiums for the six months ended June 30, 2001, and for the years ended December 31, 2000, 1999, and 1998 were as follows:

FOR THE	GROUP HEALTH INSURANCE				GROUP LIFE
	MEDICAL INSURANCE PREMIUMS	MEDICARE SUPPLEMENT INSURANCE PREMIUMS(1)	DENTAL AND VISION INSURANCE PREMIUMS	DISABILITY INSURANCE PREMIUMS	LIFE INSURANCE PREMIUMS
	(\$ IN MILLIONS)				
Six months ended June 30, 2001.....	\$ 754.6	\$ --	\$174.9	\$48.7	\$112.6
Year ended December 31, 2000.....	1,601.8	98.4	332.7	92.9	277.7
Year ended December 31, 1999.....	1,563.5	164.6	259.0	84.5	273.6
Year ended December 31, 1998.....	1,523.0	121.2	202.7	81.1	350.8

(1) Effective January 1, 2000, we ceased new sales of our Medicare supplement insurance and effective July 1, 2000, reinsured all existing business.

**MORTGAGE BANKING.** We believe residential mortgages play a central role in the financial planning activities of individuals in the United States. As a result, our mortgage banking operations complement our portfolio of market-driven financial products and services.

Interest rate trends significantly impact our residential mortgage business. Since 1998, interest rates in the U.S. have remained relatively lower than in the early 1990s. During 1998 and through most of 1999, the strong economy coupled with relatively low interest rates created a favorable real estate market that increased production of residential mortgage loans throughout the industry and also contributed to an increase in residential mortgage loan refinancing. Starting late in 1999, interest rates increased, resulting in decreases in production and refinancing of residential mortgage loans throughout the industry. This trend reversed in the first six months of 2001, when interest rates decreased, resulting in significant increases in mortgage loan production.

We manage growth in the mortgage loan servicing portfolio, through retention of mortgage loan production and the sale and acquisition of mortgage loan servicing rights. Our servicing portfolio grew at a compound annual rate of 15% from December 31, 1998 through December 31, 2000, reflecting our increased retention of servicing rights of loans produced and acquisition of servicing rights. Growth in the mortgage loan servicing portfolio was slower in 2000, as a result of a decrease in mortgage loan production and an increase in sales of mortgage loan servicing rights. In the first six months of 2001, the mortgage loan servicing portfolio grew as a result of an increase in mortgage loan production.

Our residential mortgage loan production and the unpaid principal balances in our residential mortgage loan servicing portfolio as of or for the six months ended June 30, 2001, and as of or for the years ended December 31, 2000, 1999, and 1998 were as follows:

AS OF OR FOR THE	RESIDENTIAL MORTGAGE LOAN PRODUCTION	RESIDENTIAL MORTGAGE LOAN SERVICING PORTFOLIO
	(\$ IN MILLIONS)	
Six months ended June 30, 2001.....	\$15,368.4	\$64,439.5
Year ended December 31, 2000.....	8,311.8	55,987.4
Year ended December 31, 1999.....	13,307.3	51,875.5
Year ended December 31, 1998.....	12,120.5	41,973.0

#### INVESTMENT ACTIVITY

Our primary investment objective is to maximize after-tax investment returns within risk parameters we view as acceptable.

Sales of equity securities during the six months ended June 30, 2001, generated net realized capital losses and reflected the continued repositioning of our portfolio into assets with higher yields with less volatility. The majority of the losses related to our withdrawal from company-sponsored funds during the first half of 2001 at a time of general equity market decline. In addition, we realized losses from the sales of two equity securities we received in exchange for fixed maturity securities. These sales contributed to net realized capital losses of \$56.9 million for the six months ended June 30, 2001.

In 2000 and 1999, we sold lower yielding fixed maturity securities to allow for reinvestment in higher yielding fixed maturity securities. This repositioning of our investment portfolio generated net realized capital losses in our fixed maturity security portfolio. Net realized capital losses related to fixed maturities were \$125.9 million and \$96.9 million for the years ended

December 31, 2000 and 1999, respectively.

In 1999 and 1998, we began repositioning our investment portfolio by selling invested assets with lower yields, primarily equity securities and real estate, and reinvesting the proceeds in assets with higher yields, primarily fixed maturities. Net realized capital gains related to equity securities were \$383.0 million and \$302.9 million for the years ended December 31, 1999 and 1998, respectively. Net realized capital gains related to real estate were \$56.4 million and \$120.6 million for the years ended December 31, 1999 and 1998, respectively.

In 1999, we sold a portion of our investment in United Payors and United Providers, a publicly traded service organization that acts as an intermediary between health care payors and health care providers, realizing an after-tax capital gain of \$17.9 million. In 2000, we sold our remaining investment and realized an after-tax capital gain of \$58.9 million.

#### TRANSACTIONS AFFECTING COMPARABILITY OF RESULTS OF OPERATIONS

##### ACQUISITIONS AND DISPOSITIONS

We acquired and disposed of the following businesses, among others, during the past several years:

**PT ASURANSI JIWA PRINCIPAL INDONESIA.** On September 25, 2001, we disposed of all the stock of PT Asuransi Jiwa Principal Indonesia, our subsidiary in Indonesia. We currently have no business operations in Indonesia. Total assets of our operations in Indonesia as of June 30, 2001 were \$3.4 million. We included nominal revenues and net loss from our operations in Indonesia in our consolidated results of operations for the six months ended June 30, 2001 and 2000, and for the years ended December 31, 2000, 1999 and 1998.

**PRINCIPAL INTERNATIONAL ESPANA, S.A. DE SEGUROS DE VIDA.** On February 15, 2001, we disposed of all of the stock of Principal International Espana, S.A. de Seguros de Vida, our subsidiary in Spain, for nominal proceeds, resulting in a net realized capital loss of \$38.4 million, ceasing our business operations in Spain. Total assets of our operations in Spain as of December 31, 2000 were \$222.7 million.

We included revenues of \$33.1 million from our operations in Spain in our consolidated results of operations for the six months ended June 30, 2000, and revenues of \$49.4 million, \$51.7 million and \$46.0 million in our results of operations for the years ended December 31, 2000, 1999 and 1998, respectively. We included net income of \$2.2 million from our operations in Spain for the six months ended June 30, 2000, and a net loss of \$1.2 million and net income of \$0.9 million and \$2.8 million in our results of operations for the years ended December 31, 2000, 1999 and 1998, respectively. We did not include revenues or net income from our operations in Spain in our consolidated results of operations for the six months ended June 30, 2001.

**BT FINANCIAL GROUP.** On August 31, 1999, we acquired several companies affiliated with Bankers Trust Australia Group from Deutsche Bank AG at a purchase price of \$1.4 billion. The acquired companies now operate under the name of BT Financial Group. We accounted for the acquisition using the purchase method. The results of operations of the acquired companies have been included in our consolidated financial statements from the date of acquisition. We included revenues of \$122.5 million and net loss of \$5.8 million in our consolidated results of operations for the six months ended June 30, 2001. We included revenues of \$145.4 million and net income of \$6.2 million in our consolidated results of operations for the six months ended June 30, 2000. We included revenues of \$285.5 million and net income of \$6.5 million in our consolidated results of operations for the year ended December 31, 2000. We included revenues of \$116.5 million and net loss of \$3.1 million in our consolidated results of operations for the year ended December 31, 1999.

We accounted for the purchase price as follows: \$897.4 million of identifiable intangibles, consisting primarily of management rights and the BT brand name, \$38.5 million of workforce intangibles and \$408.6 million of resulting goodwill. We are amortizing these intangible assets on a straight-line basis over 40 years, 8 years and 25 years, respectively. We report the goodwill and other intangibles, including the related amortization, in our International Asset Management and Accumulation segment. The accounting for business combinations, goodwill and other intangible assets will change effective January 1, 2002. The accounting change includes the adoption of a non-amortization, impairment-only model for our goodwill and indefinite-lived intangible assets and a more stringent test methodology for measuring and recognizing impairment losses. We are presently studying the impact the accounting change will have on our accounting policies. See "Risk Factors -- We may experience volatility in net income due to recent changes in standards for accounting for business combinations, goodwill and other intangible assets."

We issued unsecured long-term debt of \$665.0 million to partially fund our acquisition of BT Financial Group. We report this debt and related interest expense in our Corporate and Other segment.

**COMPANIA DE SEGUROS DE VIDA EL ROBLE S.A.** We acquired Compania de Seguros de Vida El Roble S.A., or El Roble, a Chilean life insurance company, at a purchase price of \$73.4 million in July 1998. We included El Roble's financial results in our International Asset Management and Accumulation segment. The operations of our existing Chilean life insurance affiliate were combined with the operations of El Roble to form Principal International de Chile. Our consolidated financial results related to these companies' combined operations include: total revenues of \$108.6 million and \$95.7 million for the six months ended June 30, 2001 and 2000, respectively, and \$200.2 million, \$178.1 million and \$155.2 million for the years ended December 31, 2000, 1999 and 1998, respectively; and net income



of \$4.3 million and \$3.4 million for the six months ended June 30, 2001 and 2000, respectively, and \$10.2 million, \$0.5 million and \$17.0 million for the years ended December 31, 2000, 1999 and 1998, respectively.

**RELIASTAR MORTGAGE CORPORATION.** In July 1998, we established our residential mortgage loan wholesale distribution system, a new distribution channel, by acquiring ReliaStar Mortgage Corporation at a purchase price of \$18.6 million. The operations of ReliaStar Mortgage Corporation have been integrated into Principal Residential Mortgage, Inc., as part of our Mortgage Banking segment.

**COVENTRY HEALTH CARE.** Effective April 1, 1998, we transferred substantially all of our HMO operations to Coventry Health Care, Inc., or Coventry, in exchange for 42% of the common stock of Coventry. Our net equity in the transferred HMO operations had a carrying value of \$170.0 million on April 1, 1998. We sold our remaining HMO operations in 1998 for \$20.5 million resulting in no realized capital gain or loss. Prior to the transfer to Coventry, our Corporate and Other segment included \$266.7 million of HMO revenues in our results for 1998.

We report our investment in Coventry in our Corporate and Other segment and account for it using the equity method. Our share of Coventry's net income was \$9.7 million and \$10.8 million for the six months ended June 30, 2001 and 2000, respectively, and \$20.0 million and \$19.1 million for the years ended December 31, 2000 and 1999, respectively. Our share of Coventry's net loss was \$9.8 million for the year ended December 31, 1998. In September 2000, we sold a portion of our Coventry stock, which reduced our ownership to approximately 25% of Coventry and resulted in a realized capital gain of \$13.9 million, net of tax. Our carrying amount in Coventry was \$134.6 million as of June 30, 2001.

**PRINCIPAL CAPITAL MANAGEMENT.** We transferred our U.S. investment management operations from our Corporate and Other segment to our U.S. Asset Management and Accumulation segment effective January 1, 1999. In connection with this transfer, we established Principal Capital Management to consolidate our U.S. asset management operations. Principal Capital Management is primarily composed of the former investment department of Principal Life and the investment professionals of Invista Capital Management, a registered investment advisor focused on the specialized needs of institutional clients. We included fee revenues of \$14.3 million and \$14.8 million for the six months ended June 30, 2001 and 2000, respectively, and \$31.5 million and \$36.2 million for the years ended December 31, 2000 and 1999, respectively, related to our third-party clients in our U.S. Asset Management and Accumulation segment. Prior to the formation of Principal Capital Management, we included fee revenues of \$10.6 million in 1998, related to our third-party clients in our Corporate and Other segment.

#### REINSURANCE TRANSACTIONS

We are considering entering into a reinsurance agreement to reduce the volatility of our group medical insurance earnings.

Effective July 1, 2000, we entered into a reinsurance agreement with General & Cologne Life Re of America to reinsure 100% of our Medicare supplement insurance business. Medicare supplement insurance premiums were \$98.4 million and \$75.9 million for the six months ended June 30, 2000 and 1999, respectively, and \$164.6 million and \$121.2 million for the years ended December 31, 1999 and 1998, respectively.

#### OPERATING EARNINGS AND NON-RECURRING ITEMS

For the six months ended June 30, 2001, we excluded \$31.4 million of non-recurring items, net of tax, from net income for our presentation of consolidated operating earnings. The non-recurring items included the negative effects of: (1) expenses related to our demutualization (\$14.8 million); (2) a cumulative effect of change in accounting principle related to our implementation of SFAS 133 (\$10.7 million), as discussed in Note 2 to Principal Mutual Holding Company's unaudited consolidated financial statements; and (3) a loss contingency reserve established for sales practices litigation (\$5.9 million).

For the six months ended June 30, 2000, we excluded \$75.8 million of non-recurring items, net of tax, from net income for our presentation of consolidated operating earnings. The non-recurring items included the negative effects of: (1) a loss contingency reserve established for sales practices litigation (\$75.0 million), and (2) expenses related to our demutualization (\$0.8 million). See "Business -- Legal Proceedings".

For the year ended December 31, 2000, we excluded \$101.0 million of non-recurring items, net of tax, from net income for our presentation of consolidated operating earnings. The non-recurring items included the negative effects of: (1) a loss contingency reserve established for sales practices litigation (\$93.8 million), and (2) expenses related to our demutualization (\$7.2 million). See "Business -- Legal Proceedings".

For the year ended December 31, 1998, we excluded \$104.8 million of non-recurring items, net of tax, from net income for our presentation of consolidated operating earnings. The non-recurring items included:

- the positive effects of: (1) Principal Life's release of tax reserves and related accrued interest in the amount of \$164.4 million, consisting of \$145.4 million in taxes and \$19.0 million of interest, resulting from the decision of the Internal Revenue Service in 1998 to accept Principal Life's position on previously contested tax matters, and (2) accounting changes by our international operations (\$13.3 million); and



- the negative effects of: (1) expenses and adjustments for changes in amortization assumptions for deferred policy acquisition costs related to our corporate structure change to a mutual insurance holding company (\$27.4 million), and (2) a contribution related to permanent endowment of the Principal Financial Group Foundation (\$45.5 million).

#### FLUCTUATIONS IN FOREIGN CURRENCY TO U.S. DOLLAR EXCHANGE RATES

Fluctuations in foreign currency to U.S. dollar exchange rates for countries in which we have operations can affect reported financial results. In years when foreign currencies weaken against the U.S. dollar, translating foreign currencies into U.S. dollars results in fewer U.S. dollars to be reported. When foreign currencies strengthen, translating foreign currencies into U.S. dollars results in more U.S. dollars to be reported.

Foreign currency exchange rate fluctuations have not had a material impact on our consolidated financial results. Our consolidated operating earnings were negatively impacted \$0.8 million for the six months ended June 30, 2001, \$0.6 million for the year ended December 31, 2000 and \$0.3 million for the year ended December 31, 1999, as a result of fluctuations in foreign currency to U.S. dollar exchange rates. For a discussion of our approaches to foreign currency exchange rate risk, see "-- Quantitative and Qualitative Information about Market Risk."

#### THE MUTUAL INSURANCE HOLDING COMPANY REORGANIZATION

Effective July 1, 1998, Principal Mutual Life Insurance Company formed Principal Mutual Holding Company, a mutual insurance holding company, and converted to Principal Life, a stock life insurance company. All of the shares of Principal Life were issued to Principal Mutual Holding Company through two newly formed Iowa intermediate holding companies, Principal Financial Group, Inc., and Principal Financial Services, Inc. The reorganization itself did not have a material financial impact on Principal Mutual Holding Company and its subsidiaries, including Principal Life, as the net assets transferred to achieve the change in legal organization were accounted for at historical carrying amounts in a manner similar to that in pooling-of-interests accounting.

In conjunction with the formation of the mutual insurance holding company, Principal Life established a Closed Block for the benefit of individual participating dividend-paying policies in force on that date. The Closed Block was designed to provide reasonable assurance to policyholders included in the Closed Block that, after the formation of the mutual insurance holding company, assets would be available to maintain dividends in aggregate in accordance with the 1997 policy dividend scales if the experience underlying such scales continued. Assets were allocated to the Closed Block in amounts such that their cash flows, together with anticipated revenues from policies included in the Closed Block, were reasonably expected to be sufficient to support such policies, including provision for payment of claims, expenses, charges and taxes, and to provide for the continuation of dividends in aggregate in accordance with the 1997 policy dividend scales if the experience underlying such scales continued, and to allow for appropriate adjustments in such scales if the experience changes.

Assets allocated to the Closed Block inure to the benefit of the holders of policies included in the Closed Block. Closed Block assets and liabilities are carried on the same basis as similar assets and liabilities held by Principal Mutual Holding Company. Principal Life will continue to pay guaranteed benefits under all policies, including the policies included in the Closed Block, in accordance with their terms. If the assets allocated to the Closed Block, the investment cash flows from those assets and revenues from the policies included in the Closed Block, including investment income thereon, prove to be insufficient to pay the benefits guaranteed under the policies included in the Closed Block, Principal Life will be required to make such payments from its general funds.

The formation of the Closed Block in 1998 did not have a material impact on our financial results. As of June 30, 2001, Closed Block assets and liabilities were \$4,613.4 million and \$5,635.8 million, respectively. As of December 31, 2000, Closed Block assets and liabilities were \$4,526.4 million and \$5,566.8 million, respectively. As of December 31, 1999, Closed Block assets and liabilities were \$4,338.3 million and \$5,415.5 million, respectively.

#### THE DEMUTUALIZATION

The board of directors of Principal Mutual Holding Company unanimously adopted the plan of conversion on March 31, 2001. Under the terms of the plan of conversion, on the effective date of the demutualization, which is the date of the closing of this offering, Principal Mutual Holding Company will convert from a mutual insurance holding company into a stock company and become our wholly-owned subsidiary.

The demutualization will become effective on the date of the closing of this offering. The plan of conversion provides that the effective date will occur after the approval by the Insurance Commissioner of the State of Iowa and the policyholders entitled to vote on the plan of conversion, but on or before 12 months after the date on which the Insurance Commissioner of the State of Iowa approves the plan of conversion. With the approval of the Insurance Commissioner of the State of Iowa, the effective date deadline may be extended.

The policyholders entitled to vote on the plan of conversion approved the plan of conversion at a meeting held on July 24, 2001, by approximately 92% of the votes cast. The public hearing was held on July 25, 2001 and the Insurance Commissioner of the State of Iowa approved the plan of conversion on August 28, 2001.

We estimate that costs relating to the demutualization, excluding costs relating to this offering, will be approximately \$25.7 million, net of tax, of which \$22.0 million was incurred through June 30, 2001. Demutualization expenses consist primarily of printing and mailing costs and our aggregate cost of engaging independent accounting, actuarial, financial, investment banking, legal and other consultants to advise us on the demutualization. In addition, our costs include the costs of the staff and advisors of the Insurance Commissioner of the State of Iowa, the New York State Insurance Department and potentially other regulatory authorities as to the demutualization process and related matters.

## RECENT DEVELOPMENTS

### TERRORIST ATTACKS IN THE UNITED STATES

On September 11, 2001, terrorist attacks in the U.S. resulted in significant loss of life and property, as well as interruption of business activities and an overall disruption of the world economy. We estimate our losses from insurance claims from these events, primarily individual life insurance claims, to be between \$9.0 million and \$12.0 million after taxes, taking into consideration reinsurance coverage. Our estimated losses will be reported in our Life and Health Insurance segment.

We do not engage in any property and casualty insurance or any reinsurance businesses. Additionally, we do not have significant insurance exposures to businesses in the affected areas and did not experience a material increase in claims related to our group life, health or disability policies. We do not have any material exposure in our investment portfolio to real estate in lower Manhattan.

The impact of the events of September 11, 2001 has reduced our assets under management as a result of the declines in the U.S., Australian and other stock markets. These declines in the securities markets and reduced commercial and economic activity may also decrease our net income and revenue. Some of the assets in our investment portfolio may also be adversely affected by the declines in the securities markets and economic activity caused by the terrorist attacks and possible military action and heightened security measures. In particular, this may lead to possible write-downs, loss of value or impairments with regard to securities issued by companies affected by these events. Credit rating agencies have downgraded, and may in the future downgrade, some of these companies, as a result of the impacts of the terrorist attacks. See "Risk Factors -- The impact of recent terrorist attacks and possible military and other actions may result in decreases in our net income, revenue and assets under management and may adversely affect our investment portfolio." In addition, declines in the securities markets and reduced commercial and economic activity may impact our assumptions in assessing the value of intangibles from prior acquisitions and the amortization patterns for deferred acquisition costs. In the event there is a need to change our assumptions, this may lead to a material impairment of these assets. See "Risk Factors -- We may experience volatility in net income due to recent changes in standards for accounting for business combinations, goodwill and other intangible assets."

### OUTLOOK FOR THREE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2000

The following discussion provides our summary outlook for our consolidated results of operations for the three months ended September 30, 2001, as compared to summary consolidated financial results for the three months ended September 30, 2000. In addition, we have provided summary consolidated financial results for the three months ended June 30, 2001. See "-- Forward-Looking Information".

Consolidated total revenues were \$2,123.8 million for the three months ended September 30, 2000. We anticipate an increase in consolidated total revenues for the three months ended September 30, 2001, primarily due to an expected increase in sales of single premium group annuities with life contingencies in our U.S. Asset Management and Accumulation and International Asset Management and Accumulation segments. Our consolidated total revenues were \$2,084.7 million for the three months ended June 30, 2001.

Consolidated operating earnings were \$163.3 million for the three months ended September 30, 2000. We anticipate that consolidated operating earnings for the three months ended September 30, 2001, will be approximately the same level. We expect an increase in Mortgage Banking segment operating earnings, primarily resulting from an increase in mortgage loan production volume, which we anticipate to be partially offset by a decrease in the value of our mortgage loan servicing portfolio. We also expect an increase in Life and Health Insurance segment operating earnings, primarily due to an anticipated improvement in group health insurance loss ratios. These increases are expected to be partially offset by a decrease in Corporate and Other segment operating earnings, primarily due to lower investment earnings, and a decrease in U.S. Asset Management and Accumulation segment operating earnings, primarily a result of the recent declines in the U.S. equity markets. Our consolidated operating earnings were \$190.3 million for the three months ended June 30, 2001.



Consolidated net income was \$173.9 million for the three months ended September 30, 2000. We expect a decrease in consolidated net income for the three months ended September 30, 2001, primarily due to anticipated lower levels of net realized capital gains and, to a lesser extent, anticipated permanent impairments of fixed maturity securities. Accordingly, our anticipated consolidated net income for the three months ended September 30, 2001 is expected to be approximately the same level as consolidated net income of \$119.1 million for the three months ended June 30, 2001.

#### RESULTS OF OPERATIONS

The table below presents summary consolidated financial information for the periods indicated.

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
(\$ IN MILLIONS)					
<b>INCOME STATEMENT DATA:</b>					
<b>Revenues:</b>					
Premiums and other considerations.....	\$1,955.3	\$1,992.7	\$3,996.4	\$3,937.6	\$3,818.4
Fees and other revenues.....	856.3	783.2	1,576.3	1,287.3	978.8
Net investment income.....	1,686.0	1,558.1	3,172.3	3,072.0	2,933.9
Net realized capital gains (losses).....	(176.9)	31.5	139.9	404.5	465.8
<b>Total revenues.....</b>	<b>4,320.7</b>	<b>4,365.5</b>	<b>8,884.9</b>	<b>8,701.4</b>	<b>8,196.9</b>
<b>Expenses:</b>					
Benefits, claims and settlement expenses.....	2,639.2	2,631.1	5,232.3	5,260.9	5,089.0
Dividends to policyholders.....	162.1	155.8	312.7	304.6	298.7
Operating expenses.....	1,228.2	1,228.0	2,479.4	2,070.3	2,074.0
<b>Total expenses.....</b>	<b>4,029.5</b>	<b>4,014.9</b>	<b>8,024.4</b>	<b>7,635.8</b>	<b>7,461.7</b>
Income before income taxes and cumulative effect of accounting change.....	291.2	350.6	860.5	1,065.6	735.2
Income taxes.....	56.1	105.3	240.3	323.5	42.2
Income before cumulative effect of accounting change....	235.1	245.3	620.2	742.1	693.0
Cumulative effect of accounting change, net of related income taxes.....	(10.7)	--	--	--	--
<b>Net income.....</b>	<b>\$ 224.4</b>	<b>\$ 245.3</b>	<b>\$ 620.2</b>	<b>\$ 742.1</b>	<b>\$ 693.0</b>
<b>OTHER DATA:</b>					
Net income.....	\$ 224.4	\$ 245.3	\$ 620.2	\$ 742.1	\$ 693.0
Less:					
Net realized capital gains (losses), as adjusted.....	(108.2)	23.1	93.1	266.9	320.7
Non-recurring items.....	(31.4)	(75.8)	(101.0)	--	104.8
<b>Operating earnings.....</b>	<b>\$ 364.0</b>	<b>\$ 298.0</b>	<b>\$ 628.1</b>	<b>\$ 475.2</b>	<b>\$ 267.5</b>
Operating earnings before amortization of goodwill and other intangibles.....	\$ 385.6	\$ 317.9	\$ 670.8	\$ 492.0	\$ 304.0

#### SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

Premiums and other considerations decreased \$37.4 million, or 2%, to \$1,955.3 million for the six months ended June 30, 2001, from \$1,992.7 million for the six months ended June 30, 2000. The decrease reflected a \$167.7 million, or 10%, decrease from the Life and Health Insurance segment, primarily related to our decision to reinsure 100% of our group Medicare supplement insurance business effective July 1, 2000. Life and Health Insurance segment premiums also decreased due to large premium rate increases in 2000, which led to increased lapses and lower sales of group medical insurance. The decrease was partially offset by a \$129.2 million, or 64%, increase from the U.S. Asset Management and Accumulation segment, primarily due to an increase in premiums from single premium group annuities with life contingencies, which are typically used to fund defined benefit pension plan terminations. The premium income we receive from these contracts fluctuates due to the variability in the number and size of pension plan terminations in the market and our ability to attract new sales. The decrease was also partially offset by a \$1.1 million, or 1%, increase from the International Asset Management and Accumulation segment, primarily related to increased sales of single premium annuities with life contingencies in Mexico, which was offset by the loss of premiums and other considerations due to the February 2001 divestiture of our operations in Spain.

Fees and other revenues increased \$73.1 million, or 9%, to \$856.3 million for the six months ended June 30, 2001, from \$783.2 million for the six months ended June 30, 2000. The increase was primarily due to a \$105.1 million, or 57%, increase from the Mortgage Banking segment, primarily resulting from an increase in mortgage loan production

fee revenues, reflecting the increase in mortgage loan production volume. The increase was also due to a \$23.9 million, or 23%, increase from the Life and Health Insurance segment, primarily related to an increase in group fee-for-service fee revenues, a result of fee rate increases and growth in that business, and an increase in interest-sensitive life insurance fee revenues, a result of growth in that block of business. The increases were partially offset by a \$31.3 million, or 9%, decrease from the U.S. Asset Management and Accumulation segment, primarily due to a decrease in surrender charge revenues from pension products, as fewer customers surrendered their products due to the declining interest rate environment. The increases were also partially offset by a \$13.5 million, or 9%, decrease from the International Asset Management and Accumulation segment, primarily as a result of the weakening of the Australian dollar versus the U.S. dollar. The increases were also partially offset by an \$11.1 million, or 90%, decrease from the Corporate and Other segment, primarily related to inter-segment eliminations included in this segment.

Net investment income increased \$127.9 million, or 8%, to \$1,686.0 million for the six months ended June 30, 2001, from \$1,558.1 million for the six months ended June 30, 2000. The increase was primarily due to a \$2,034.5 million, or 5%, increase in average invested assets and cash and also to an increase in investment yields, a result of higher yields on fixed income securities. The yield on average invested assets and cash was 7.7% for the six months ended June 30, 2001, compared to 7.4% for the six months ended June 30, 2000.

Net realized capital gains (losses) decreased \$208.4 million to \$176.9 million of net realized capital losses for the six months ended June 30, 2001, from \$31.5 million of net realized capital gains for the six months ended June 30, 2000. The decrease primarily related to realized capital losses on equity securities recognized during the six months ended June 30, 2001, a result of the decline in the equity markets, compared to realized gains on equity securities recognized during the six months ended June 30, 2000. In addition, we sold our investment in United Payors and United Providers, and realized a capital gain of \$90.6 million, during the six months ended June 30, 2000. Permanent impairments of fixed maturity securities, during the six months ended June 30, 2001, and a realized capital loss on the sale of our operations in Spain, also contributed to the decrease.

Benefits, claims and settlement expenses increased \$8.1 million to \$2,639.2 million for the six months ended June 30, 2001, from \$2,631.1 million for the six months ended June 30, 2000. The increase was primarily due to a \$148.2 million, or 14%, increase from the U.S. Asset Management and Accumulation segment, primarily due to the increase in reserves resulting from an increase in sales of single premium group annuities with life contingencies. The increase was also due to a \$12.7 million, or 10%, increase from the International Asset Management and Accumulation segment, primarily due to an increase in the change in reserves and policy and contract benefit payments, primarily related to additional sales of annuity products with life contingencies in Mexico and Argentina. The increases were partially offset by a \$119.6 million, or 9%, decrease from the Life and Health Insurance segment, primarily related to our decision to reinsure 100% of our group Medicare supplement insurance business effective July 1, 2000. The increases were also partially offset by a \$33.2 million, or 100%, decrease from the Corporate and Other segment, primarily related to a non-recurring loss contingency reserve established during the six months ended June 30, 2000, for sales practices litigation.

Dividends to policyholders increased \$6.3 million, or 4%, to \$162.1 million for the six months ended June 30, 2001, from \$155.8 million for the six months ended June 30, 2000. The increase was primarily attributable to a \$4.4 million, or 3%, increase from the Life and Health Insurance segment due to increased dividends on traditional life insurance products, a result of increases in the cash value of the policies. The increase was also due to a \$1.9 million, or 100%, increase from the U.S. Asset Management and Accumulation segment resulting from an increase in dividends for our pension full-service accumulation products.

Operating expenses increased \$0.2 million to \$1,228.2 million for the six months ended June 30, 2001, from \$1,228.0 million for the six months ended June 30, 2000. The increase was primarily due to a \$59.6 million, or 47%, increase from the Mortgage Banking segment, primarily due to mortgage loan servicing expenses, reflecting the growth in the mortgage loan servicing portfolio. The increase also reflected a \$33.6 million, or 9%, increase from the U.S. Asset Management and Accumulation segment, primarily resulting from an increase in pension compensation costs resulting from growth in operations; an increase related to the net impact of capitalization and amortization of deferred policy acquisition costs attributable to pension products; and an increase in Principal Bank operating expenses primarily related to growth in bank operations. The increases were partially offset by a \$67.4 million, or 60%, decrease from the Corporate and Other segment, primarily related to a non-recurring loss contingency reserve established during the six months ended June 30, 2000, for sales practices litigation. The increases were also partially offset by a \$19.0 million, or 4%, decrease from the Life and Health Insurance segment, primarily a result of a decrease in commissions resulting from our decision to reinsure 100% of our group Medicare supplement insurance business effective July 1, 2000. In addition, the increases were partially offset by a \$6.6 million, or 4%, decrease from the International Asset Management and Accumulation segment, primarily as a result of the weakening of the Australian dollar versus the U.S. dollar.

Income taxes decreased \$49.2 million, or 47%, to \$56.1 million for the six months ended June 30, 2001, from \$105.3 million for the six months ended June 30, 2000. The effective income tax rate was 19% for the six months ended June 30, 2001, and 30% for the six months ended June 30, 2000. The effective income tax rates for the six months ended June 30, 2001 and 2000 were lower than the corporate rate of 35%, primarily due to income tax deductions allowed for corporate dividends received, for which the estimated benefit recognition rate



the six months ended June 30, 2001, compared to the six months ended June 30, 2000. The effective income tax rate for the six months ended June 30, 2001, was further reduced by additional tax benefits related to excess tax over book capital losses realized from the sale of our operations in Spain.

As a result of the foregoing factors and the inclusion of the cumulative effect of accounting change, net of related income taxes, net income decreased \$20.9 million, or 9%, to \$224.4 million for the six months ended June 30, 2001, from \$245.3 million for the six months ended June 30, 2000. The cumulative effect of accounting change was related to our implementation of SFAS 133, as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items."

During the six months ended June 30, 2001, non-recurring items of \$31.4 million, net of tax, included the negative effects of: (1) expenses related to our demutualization (\$14.8 million); (2) a cumulative effect of change in accounting related to our implementation of SFAS 133 (\$10.7 million); and (3) a loss contingency reserve established for sales practices litigation (\$5.9 million). During the six months ended June 30, 2000, non-recurring items of \$75.8 million, net of tax, included the negative effects of: (1) a loss contingency reserve established for sales practices litigation (\$75.0 million); and (2) expenses related to our demutualization (\$0.8 million).

As a result of the foregoing factors and the exclusion of net realized capital gains (losses), as adjusted and nonrecurring items, operating earnings increased \$66.0 million, or 22%, to \$364.0 million for the six months ended June 30, 2001, from \$298.0 million for the six months ended June 30, 2000. The increase resulted from a \$34.4 million, or 100%, increase from the Mortgage Banking segment, primarily due to an increase in mortgage loan production earnings, reflecting an increase in mortgage loan production volume. The increase was also due to a \$28.1 million increase from the Corporate and Other segment, primarily due to improved investment yields. In addition, the increase was due to a \$4.9 million, or 6%, increase from the Life and Health Insurance segment, primarily due to improved margins on individual life insurance business resulting from higher investment yields and due to improved loss ratios on group disability insurance. The increases were partially offset by a \$1.0 million, or 27%, decrease from the International Asset Management and Accumulation segment and a \$0.4 million decrease from the U.S. Asset Management and Accumulation segment.

#### YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

Premiums and other considerations increased \$58.8 million, or 1%, to \$3,996.4 million in 2000, from \$3,937.6 million in 1999. The increase reflected a \$59.9 million, or 2%, increase from the Life and Health Insurance segment, primarily the result of increased sales of group dental insurance products and an increase in group medical premiums, primarily attributable to increased sales in 1999 and significant group medical premium rate increases. In addition, the increase was due to a \$40.6 million, or 23%, increase from the International Asset Management and Accumulation segment, primarily related to sales of single premium annuities with life contingencies by new annuity companies we established in Mexico in July 1999 and in Argentina in August 1999. The increases were partially offset by a \$41.3 million, or 7%, decrease from the U.S. Asset Management and Accumulation segment, primarily related to a decrease in premiums from single premium group annuities with life contingencies, which are typically used to fund defined benefit pension plan terminations. The premium income we receive from these contracts fluctuates due to the variability in the number and size of defined benefit pension plan terminations in the market and our ability to attract new sales.

Fees and other revenues increased \$289.0 million, or 22%, to \$1,576.3 million in 2000, from \$1,287.3 million in 1999. The increase was primarily due to a \$199.6 million increase from the International Asset Management and Accumulation segment, primarily resulting from the inclusion of fees and other revenues contributed by BT Financial Group, which we acquired in August 1999. The increase was also due to a \$90.3 million, or 15%, increase from the U.S. Asset Management and Accumulation segment, primarily attributable to an increase in administrative fee revenues, reflecting an increase in the amortization of front-end fee revenues, a result of a change in our assumptions related to amortization of deferred policy acquisition costs attributable to pension products. We also received higher fee revenues related to surrender charges, which are fees charged to policyholders when they surrender an annuity for its cash value. Fee revenues also increased due to fees from pension customer-directed investment transfers, reflecting the higher interest rate environment and the resulting increased customer account activity. Fee revenues for U.S. pension products and services also increased, reflecting increased assets under management in 1999. The increase was also due to a \$49.8 million, or 28%, increase from the Life and Health Insurance segment, primarily related to growth in our interest-sensitive life insurance block of business and increased fee revenues from our group fee-for-service business, primarily a result of an increase in members and fees. The increases were partially offset by a \$31.2 million decrease from the Corporate and Other segment, which reflects a change in inter-segment eliminations included in this segment and the termination of a reinsurance and participation agreement under which we received fee revenues in 1999, but not in 2000. The increases were also partially offset by a \$19.5 million, or 5%, decrease from the Mortgage Banking segment, primarily due to a decrease in residential mortgage loan production revenues as a result of the decrease in residential mortgage loan production volume during 2000.

Net investment income increased \$100.3 million, or 3%, to \$3,172.3 million in 2000, from \$3,072.0 million in 1999. The increase was primarily due to an increase in investment yields due to higher interest rates on new investments.

The yield on average invested assets and cash was 7.5% in 2000, compared to 7.4% in 1999. The increase was also due to a \$934.8 million, or 2%, increase in average invested assets and cash.

Net realized capital gains decreased \$264.6 million, or 65%, to \$139.9 million in 2000, from \$404.5 million in 1999. The decrease was due in part to a decrease in sales of invested assets, primarily equity securities, in 2000. In 1999, we sold a significant portion of our equity securities portfolio to reduce exposure to common stock and to realize appreciation. We also recognized an increase in net realized capital losses in 2000, compared to 1999, in our fixed income securities portfolio, reflecting our investment philosophy to reposition the investment portfolio to maximize investment returns by selling lower yielding fixed income securities to allow for reinvestment in higher yielding fixed income securities. In 1999, we sold a portion of our investment in United Payors and United Providers, a publicly traded service organization that acts as an intermediary between health care payors and health care providers, realizing a capital gain of \$27.6 million. In 2000, we sold our remaining investment and realized a capital gain of \$90.6 million.

Benefits, claims and settlement expenses decreased \$28.6 million, or 1%, to \$5,232.3 million in 2000, from \$5,260.9 million in 1999. The decrease was primarily due to a \$55.5 million, or 2%, decrease from the Life and Health Insurance segment, primarily resulting from the release of group medical and group Medicare supplement claim reserves established in 1999. The claim reserves were established in 1999 as a result of poor claim experience during the first three quarters of 1999 and an expectation that claims would continue to increase through the second quarter of 2000. Group Medicare supplement benefits, claims and settlement expenses also decreased as a result of our decision to cease new sales of group Medicare supplement insurance effective January 1, 2000 and our decision to reinsure all existing business as of July 1, 2000. In addition, the decrease was related to a \$24.7 million, or 1%, decrease from the U.S. Asset Management and Accumulation segment primarily resulting from a decrease in benefit payments and reserve changes reflecting the decrease in our block of pension experience rated business and an increase in our guaranteed business. The decreases were partially offset by a \$52.1 million, or 25%, increase from the International Asset Management and Accumulation segment, primarily due to an increase in the change in reserves and policy and contract benefit payments, primarily related to additional sales of annuity products with life contingencies in Mexico, Argentina and Chile.

Dividends to policyholders increased \$8.1 million, or 3%, to \$312.7 million in 2000, from \$304.6 million in 1999. The increase was primarily attributable to a \$12.5 million, or 4%, increase from the Life and Health Insurance segment due to increased dividends on traditional individual life insurance products, a result of increases in the cash values of the policies. The increase was partially offset by a \$4.4 million, or 49%, decrease in dividends from the U.S. Asset Management and Accumulation segment, which reflected a decrease in our block of pension experience rated business.

Operating expenses increased \$409.1 million, or 20%, to \$2,479.4 million in 2000, from \$2,070.3 million in 1999. The increase was primarily due to a \$160.2 million, or 76%, increase from the International Asset Management and Accumulation segment, primarily resulting from the inclusion of BT Financial Group in our financial results effective August 1999, including a \$23.3 million increase amortization of goodwill and other intangibles. The increase also reflected a \$121.5 million, or 20%, increase from the U.S. Asset Management and Accumulation segment, primarily due to a change in our assumptions related to amortization of deferred policy acquisition costs related to pension products and also due to an increase in pension salary and incentive compensation costs and other pension administrative expenses. In addition, the increase was due to a \$116.0 million increase from the Corporate and Other segment, primarily related to a non-recurring loss contingency reserve established for sales practices litigation and demutualization costs as well as additional interest costs related to private debt securities and commercial paper issued in connection with our acquisition of BT Financial Group. The increase was also due to a \$39.5 million, or 5%, increase from the Life and Health Insurance segment, primarily due to expenses related to our group Medicare supplement business and higher group medical commissions. The increases were partially offset by a \$28.1 million, or 9%, decrease from the Mortgage Banking segment, primarily a result of net gains we earned on hedges related to our servicing portfolio in 2000.

Income taxes decreased \$83.2 million, or 26%, to \$240.3 million in 2000, from \$323.5 million in 1999. The effective income tax rate was 28% in 2000 and 30% in 1999. The effective rates for 2000 and 1999 were lower than the corporate income tax rate of 35%, primarily due to income tax deductions allowed for corporate dividends received.

As a result of the foregoing factors, net income decreased \$121.9 million, or 16%, to \$620.2 million in 2000, from \$742.1 million in 1999.

In 2000, non-recurring items of \$101.0 million, net of tax, included the negative effects of (1) a loss contingency reserve established for sales practices litigation (\$93.8 million); and (2) expenses related to our demutualization study (\$7.2 million).

Operating earnings increased \$152.9 million, or 32%, to \$628.1 million in 2000, from \$475.2 million in 1999. The increase resulted from a \$71.6 million, or 79%, increase from the Life and Health Insurance segment, primarily due to improved earnings from our group medical business. The increase was also due to a \$58.2 million increase from the Corporate and Other segment, primarily due to improved investment yields and lower expenses due in part to a net recovery of interest expense related to a successful tax audit appeal. In addition, the increase was due to a



\$29.9 million, or 78%, increase from the International Asset Management and Accumulation segment due to growth in our international operations, due in part to BT Financial Group, which we acquired in August 1999. Operating earnings from the U.S. Asset Management and Accumulation did not change as increases in revenues were offset by increases in expenses. These increases were partially offset by a \$6.8 million, or 12%, decrease from the Mortgage Banking segment, primarily due to a decrease in mortgage loan production earnings, reflecting a decrease in production volume.

YEAR ENDED DECEMBER 31, 1999 COMPARED TO YEAR ENDED DECEMBER 31, 1998

Premiums and other considerations increased \$119.2 million, or 3%, to \$3,937.6 million in 1999, from \$3,818.4 million in 1998. The increase was primarily due to a \$285.0 million, or 101%, increase from the U.S. Asset Management and Accumulation segment, due to increased sales of single premium group annuities with life contingencies. The premium income we receive from these contracts fluctuates due to the variability in the number and size of pension plan terminations in the market and our ability to attract new sales. The increase was also due to a \$64.0 million, or 2%, increase from the Life and Health Insurance segment, primarily due to growth in our dental insurance business, and an increase in premiums and other considerations for group Medicare supplement insurance and group medical insurance, a result of more competitive pricing and new sales incentives. The increase was also due to a \$32.8 million, or 22%, increase from the International Asset Management and Accumulation segment, primarily related to the addition of premiums from El Roble, a Chilean life insurance company we acquired in July 1998, sales of single premium annuities with life contingencies, related primarily to our newly formed annuity company in Mexico, and sales of single premium group annuities with life contingencies in Spain. The increases were partially offset by a \$262.6 million decrease from the Corporate and Other segment, primarily related to our HMO operations, which contributed premiums and other considerations through March 31, 1998, prior to being transferred to Coventry.

Fees and other revenues increased \$308.5 million, or 32%, to \$1,287.3 million in 1999, from \$978.8 million in 1998. The increase was primarily due to a \$165.7 million, or 37%, increase from the U.S. Asset Management and Accumulation segment, primarily due to growth in assets under management, which benefited from strong equity market performance in 1999, an increase in net deposits received from our pension customers and an increase in third-party asset management fee revenues. The increase in U.S. Asset Management and Accumulation segment fee revenues was related to the inclusion of asset management fee revenues of Principal Capital Management in this segment at the beginning of 1999. Such asset management fee revenues were reported in the Corporate and Other segment prior to 1999, leading to a \$35.1 million decrease for the Corporate and Other segment. This change in reported segment did not have an impact on our consolidated financial results. The increase was also due to a \$77.5 million increase from the International Asset Management and Accumulation segment, primarily related to the inclusion of fees and revenues contributed by BT Financial Group, which we acquired in August 1999. The increase was also due to a \$66.9 million, or 20%, increase from the Mortgage Banking segment, primarily due to an increase in residential mortgage loan servicing revenues resulting from the increase in our residential mortgage loan servicing portfolio. The increase was also attributable to a \$33.5 million, or 23%, increase from the Life and Health Insurance segment, primarily due to an increase in fee revenues from our group fee-for-service business, as we provided more clients with customized services that result in higher fees, and an increase in fee revenues due to increased sales of individual interest-sensitive life insurance products, a result of customer preference for universal life and variable life insurance products.

Net investment income increased \$138.1 million, or 5%, to \$3,072.0 million in 1999, from \$2,933.9 million in 1998. The increase was primarily due to higher investment yields in 1999. The yield on average invested assets and cash was 7.4% in 1999, compared to 7.2% in 1998. The increase was also due to an \$897.2 million, or 2%, increase in average invested assets. Our pro rata share of Coventry's net income increased \$28.9 million, as a result of Coventry's improved earnings in 1999 compared to 1998. In addition, BT Financial Group contributed \$18.3 million of net investment income in 1999.

Net realized capital gains, as adjusted, decreased \$61.3 million, or 13%, to \$404.5 million in 1999, from \$465.8 million in 1998. Our net realized capital gains reflect significant sales activity in both 1999 and 1998. We continued to reposition the investment portfolio to maximize operating investment returns by selling lower yielding invested assets and reinvesting in higher yielding investments. In addition, we sold a significant portion of our equity securities portfolio in 1999 and 1998 to reduce our exposure to common stock and to realize appreciation in value. Additionally, we reduced our investments in real estate in 1999 and 1998 to reduce our exposure to this asset class. We actively managed our portfolio of residential mortgage-backed securities to ensure that the securities we held traded close to or below par to manage prepayment risk. These activities resulted in the realization of capital gains and losses.

Benefits, claims and settlement expenses increased \$171.9 million, or 3%, to \$5,260.9 million in 1999, from \$5,089.0 million in 1998. The increase was primarily due to a \$288.2 million, or 14%, increase from the U.S. Asset Management and Accumulation segment, related primarily to a larger block of single premium group annuities with life contingencies. The increase was also due to a \$109.6 million, or 4%, increase from the Life and Health Insurance segment, reflecting an increase in group medical and group Medicare supplement benefits. This increase was also due to reserve changes in 1999, which were primarily due to claim reserves established as a result of poor claim

experience during the first three quarters of 1999 and an expectation that claims would continue to increase through the second quarter of 2000. The increase was also due to a \$44.9 million, or 27%, increase from the International Asset Management and Accumulation segment, primarily attributable to the addition of benefits, claims and settlement expenses from El Roble, which we acquired in July 1998, and an increase in the change in reserves due to sales of single premium group annuities with life contingencies in Spain and Mexico. The increases were partially offset by a \$270.8 million decrease from the Corporate and Other segment, primarily related to our HMO operations, which generated benefits, claims and settlement expenses in 1998, prior to being transferred to Coventry.

Dividends to policyholders increased \$5.9 million, or 2%, to \$304.6 million in 1999, from \$298.7 million in 1998. The increase was due to a \$10.3 million increase from the U.S. Asset Management and Accumulation segment, a reflection of lower dividends in 1998, as several large group annuity contracts renewed in the form of non-participating contracts in 1998. The increase was partially offset by a \$4.4 million, or 1%, decrease from the Life and Health Insurance segment, primarily related to a decrease in group life and health insurance dividends when compared to 1998. After July 1, 1998, new issues and renewals of group life and health contracts were in the form of non-participating policies. These policies included experience refund provisions that were reported as reductions of premiums in 1999, instead of as dividends to policyholders. The change in presentation did not affect net income. The Life and Health Insurance segment dividend decrease was partially offset by an increase in individual traditional life insurance dividends due to increases in the cash values of policies and in the interest rates credited to the policies.

Operating expenses decreased \$3.7 million to \$2,070.3 million in 1999, from \$2,074.0 million in 1998. The decrease was primarily due to a \$198.0 million, or 79%, decrease from the Corporate and Other segment, primarily due to our HMO operations which generated operating expenses in 1998, prior to the transfer of those operations to Coventry. The decrease was also attributable to a \$29.0 million, or 3%, decrease from the Life and Health Insurance segment, primarily related to a decrease in amortization of deferred policy acquisition costs for individual life and disability insurance in 1999, compared to 1998. Amortization was higher in 1998 due to loss recognition on older blocks of business. The decreases were partially offset by a \$120.1 million increase from the International Asset Management and Accumulation segment, primarily due to the addition of BT Financial Group in August 1999. BT Financial Group's operating expenses included \$13.7 million of amortization of goodwill and other intangibles. The decreases were also partially offset by a \$60.6 million, or 24%, increase from the Mortgage Banking segment, primarily due to an increase in amortization of residential mortgage loan servicing rights, a result of the increase in the residential mortgage loan servicing portfolio. The decreases were also partially offset by a \$42.6 million, or 7%, increase from the U.S. Asset Management and Accumulation segment, primarily related to Principal Capital Management, which was included in this segment at the beginning of 1999.

Income taxes increased \$281.3 million to \$323.5 million in 1999, from \$42.2 million in 1998. The effective income tax rate was 30% in 1999 and 6% in 1998, compared to the U.S. corporate income tax rate of 35%. The effective income tax rate was lower than the corporate income tax rate in 1999, primarily due to tax exempt income. The rate was also reduced due to higher deferred taxes related to health reserves in 1998, the effects of which were reversed in 1999. The effective income tax rate was lower than the corporate income tax rate of 35% in 1998, primarily due to Principal Life's release of a tax reserve, as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items," and related accrued interest in the amount of \$164.4 million, consisting of \$145.4 million in taxes and \$19.0 million of interest.

As a result of the foregoing factors, net income increased \$49.1 million, or 7%, to \$742.1 million in 1999, from \$693.0 million in 1998.

In 1998, non-recurring items of \$104.8 million, net of tax, included: the positive effects of (1) a favorable settlement of a contingent tax matter (\$164.4 million), see "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items," and (2) accounting changes by our international operations (\$13.3 million); and the negative effects of (1) expenses related to our corporate structure change to a mutual insurance holding company and related adjustments for changes in amortization assumptions for deferred policy acquisition costs (\$27.4 million) and (2) a contribution related to permanent endowment of the Principal Financial Group Foundation (\$45.5 million).

Operating earnings increased \$207.7 million, or 78%, to \$475.2 million in 1999, from \$267.5 million in 1998. The increase resulted from a \$118.2 million, or 50%, increase from the U.S. Asset Management and Accumulation segment, primarily resulting from growth in our pension full service accumulation business. The increase was also due to a \$53.8 million increase from the Corporate and Other segment, primarily due to the absence of losses from our HMO operations in 1999, a result of the transfer of our HMO operations to Coventry in 1998. In addition, the increase was due to a \$40.7 million, or 81%, increase from the Life and Health Insurance segment, primarily due to increased earnings from our individual life insurance business and, to a lesser extent, increases in earnings from our group disability insurance business. These increases were partially offset by a \$3.0 million, or 8%, decrease from the International Asset Management and Accumulation segment, primarily attributable to an increase in operating expenses related to BT Financial Group, which we acquired in August 1999. These increases were also partially offset by a \$2.0 million, or 3%, decrease from the Mortgage Banking segment.



## RESULTS OF OPERATIONS BY SEGMENT

We evaluate segment performance by segment operating earnings, which excludes the effect of net realized capital gains and losses, as adjusted, and non-recurring events and transactions. Segment operating earnings is determined by adjusting GAAP net income for net realized capital gains and losses, as adjusted, and non-recurring items that we believe are not indicative of overall operating trends. While these items may be significant components in understanding and assessing our consolidated financial performance, we believe the presentation of segment operating earnings enhances the understanding of our results of operations by highlighting earnings attributable to the normal, recurring operations of our businesses. However, segment operating earnings are not a substitute for net income determined in accordance with GAAP.

The following table presents segment information as of or for the six months ended June 30, 2001 and 2000, and as of or for each of the years ended December 31, 2000, 1999 and 1998:

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
	-----				
	(\$ IN MILLIONS)				
OPERATING REVENUES BY SEGMENT:					
U.S. Asset Management and Accumulation(2).....	\$ 1,858.2	\$ 1,700.7	\$ 3,533.9	\$ 3,472.6	\$ 2,933.1
International Asset Management and Accumulation.....	310.1	309.5	630.7	379.6	223.1
Life and Health Insurance.....	1,978.2	2,100.7	4,122.6	3,985.5	3,893.1
Mortgage Banking.....	293.1	180.7	359.8	398.3	340.6
Corporate and Other(1)(2).....	57.5	40.5	97.1	61.9	342.5
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Total operating revenues.....	4,497.1	4,332.1	8,744.1	8,297.9	7,732.4
Net realized capital gains (losses), including recognition of front-end fee revenues(3).....	(176.4)	33.4	140.8	403.5	464.5
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Total consolidated revenues.....	\$ 4,320.7	\$ 4,365.5	\$ 8,884.9	\$ 8,701.4	\$ 8,196.9
	=====	=====	=====	=====	=====
OPERATING EARNINGS (LOSS) BY SEGMENT:					
U.S. Asset Management and Accumulation.....	\$ 176.9	\$ 177.3	\$ 356.6	\$ 356.6	\$ 238.4
International Asset Management and Accumulation.....	(4.7)	(3.7)	(8.5)	(38.4)	(35.4)
Life and Health Insurance.....	90.9	86.0	162.3	90.7	50.0
Mortgage Banking.....	68.8	34.4	50.0	56.8	58.8
Corporate and Other.....	32.1	4.0	67.7	9.5	(44.3)
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Total operating earnings.....	364.0	298.0	628.1	475.2	267.5
Net realized capital gains (losses), as adjusted(3).....	(108.2)	23.1	93.1	266.9	320.7
Non-recurring items(4).....	(31.4)	(75.8)	(101.0)	--	104.8
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GAAP REPORTED:					
Net income.....	\$ 224.4	\$ 245.3	\$ 620.2	\$ 742.1	\$ 693.0
	=====	=====	=====	=====	=====
TOTAL ASSETS BY SEGMENT:					
U.S. Asset Management and Accumulation.....	\$66,182.4	\$65,109.4	\$65,795.9	\$65,096.4	\$58,701.5
International Asset Management and Accumulation.....	4,919.6	5,547.3	5,525.9	5,926.8	1,239.4
Life and Health Insurance.....	10,637.2	10,293.8	10,569.0	10,070.8	9,219.5
Mortgage Banking.....	2,168.9	1,606.3	1,556.3	1,737.7	1,810.4
Corporate and Other(5).....	1,321.6	1,789.5	957.8	1,121.5	3,075.9
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Total assets.....	\$85,229.7	\$84,346.3	\$84,404.9	\$83,953.2	\$74,046.7
	=====	=====	=====	=====	=====

(1) Includes inter-segment eliminations primarily related to real estate joint venture rental income and internal investment management fee revenues. The Corporate and Other segment reported rental income from real estate joint ventures for office space used by other segments.

(2) The U.S. Asset Management and Accumulation segment received fee revenues for performing investment management services for other segments in 2001, 2000 and 1999. The Corporate and Other segment received fee revenues for performing investment management services for other segments prior to 1999.

(3) Net realized capital gains (losses), as adjusted, are net of tax, related changes in the amortization pattern of deferred policy acquisition costs, recognition of front-end fee revenues for sales charges on pension products and services and net realized capital gains credited to customers. This presentation may not be comparable to presentations made by other companies.

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
	----- (\$ IN MILLIONS) -----				
Net realized capital gains (losses).....	\$ (176.9)	\$ 31.5	\$ 139.9	\$ 404.5	\$ 465.8
Recognition of front-end fee revenues.....	0.5	1.9	0.9	(1.0)	(1.3)
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Net realized capital gains (losses), including recognition of front-end fee revenues.....	(176.4)	33.4	140.8	403.5	464.5
Amortization of deferred policy acquisition costs related to net realized capital gains (losses).....	3.9	(3.4)	(0.3)	4.4	5.7
Amounts credited to contractholder accounts.....	--	--	--	--	(26.3)
Non-recurring net realized capital losses.....	--	--	--	--	(1.7)
	-----				
Net realized capital gains (losses), including recognition of front-end fee revenues, net of related amortization of deferred policy acquisition costs and amounts credited to contractholders.....	(172.5)	30.0	140.5	407.9	442.2
Income tax effect.....	64.3	(6.9)	(47.4)	(141.0)	(121.5)
	-----				
Net realized capital gains (losses), as adjusted.....	\$ (108.2)	\$ 23.1	\$ 93.1	\$ 266.9	\$ 320.7
	=====				

(4) For the six months ended June 30, 2001, non-recurring items of \$31.4 million, net of tax, included the negative effects of: (a) expenses related to our demutualization (\$14.8 million); (b) a cumulative effect of change in accounting principle related to our implementation of SFAS 133 (\$10.7 million); and (c) a loss contingency reserve established for sales practices litigation (\$5.9 million). For the six months ended June 30, 2000, non-recurring items of \$75.8 million, net of tax, included the negative effects of: (a) a loss contingency reserve established for sales practices litigation (\$75.0 million), and (b) expenses related to our demutualization (\$0.8 million). For the year ended December 31, 2000, non-recurring items of \$101.0 million, net of tax, included the negative effects of: (a) a loss contingency reserve established for sales practices litigation (\$93.8 million) and (b) expenses related to our demutualization (\$7.2 million). For the year ended December 31, 1998, non-recurring items of \$104.8 million, net of tax, included: the positive effects of (a) a favorable settlement of a contingent tax matter (\$164.4 million), see "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items," and (b) accounting changes by our international operations (\$13.3 million); and the negative effects of (a) expenses related to our corporate structure change to a mutual insurance holding company and related adjustments for changes in amortization assumptions for deferred policy acquisition costs (\$27.4 million) and (b) a contribution related to permanent endowment of the Principal Financial Group Foundation (\$45.5 million).

(5) Includes inter-segment elimination amounts related to internally generated mortgage loans and an internal line of credit. The U.S. Asset Management and Accumulation segment and Life and Health Insurance segment reported mortgage loan assets issued for real estate joint ventures. These mortgage loans were reported as liabilities in the Corporate and Other segment. In addition, the Corporate and Other segment managed a revolving line of credit used by other segments.

U.S. ASSET MANAGEMENT AND ACCUMULATION SEGMENT

The table below presents certain summary financial data relating to the U.S. Asset Management and Accumulation segment for the periods indicated:

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
	(\$ IN MILLIONS)				
<b>OPERATING EARNINGS DATA:</b>					
<b>Operating revenues(1):</b>					
Premiums and other considerations.....	\$ 330.0	\$ 200.8	\$ 525.4	\$ 566.7	\$ 281.7
Fees and other revenues.....	320.8	350.7	704.6	616.2	450.8
Net investment income.....	1,207.4	1,149.2	2,303.9	2,289.7	2,200.6
<b>Total operating revenues.....</b>	<b>1,858.2</b>	<b>1,700.7</b>	<b>3,533.9</b>	<b>3,472.6</b>	<b>2,933.1</b>
<b>Expenses:</b>					
Benefits, claims and settlement expenses, including dividends to policyholders.....	1,242.9	1,092.8	2,315.2	2,344.3	2,019.5
Operating expenses.....	399.5	359.4	740.9	626.3	592.3
<b>Total expenses.....</b>	<b>1,642.4</b>	<b>1,452.2</b>	<b>3,056.1</b>	<b>2,970.6</b>	<b>2,611.8</b>
Pre-tax operating earnings.....	215.8	248.5	477.8	502.0	321.3
Income taxes.....	38.9	71.2	121.2	145.4	82.9
<b>Operating earnings.....</b>	<b>176.9</b>	<b>177.3</b>	<b>356.6</b>	<b>356.6</b>	<b>238.4</b>
Net realized capital gains (losses), as adjusted...	(40.8)	(35.1)	(35.9)	(35.4)	14.7
Non-recurring items.....	(10.8)	--	--	--	23.9
<b>GAAP REPORTED:</b>					
<b>Net income.....</b>	<b>\$ 125.3</b>	<b>\$ 142.2</b>	<b>\$ 320.7</b>	<b>\$ 321.2</b>	<b>\$ 277.0</b>

(1) Excludes net realized capital gains (losses) and their impact on recognition of front-end fee revenues.

SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

Premiums and other considerations increased \$129.2 million, or 64%, to \$330.0 million for the six months ended June 30, 2001, from \$200.8 million for the six months ended June 30, 2000. The increase was primarily due to a \$128.5 million increase in premiums from single premium group annuities with life contingencies, which are typically used to fund defined benefit pension plan terminations. The premium income we receive from these contracts fluctuates due to the variability in the number and size of pension plan terminations in the market and our ability to attract new sales.

Fees and other revenues decreased \$29.9 million, or 9%, to \$320.8 million for the six months ended June 30, 2001, from \$350.7 million for the six months ended June 30, 2000. The decrease was primarily due to a \$32.2 million decrease in surrender charge revenues from pension products, as fewer customers surrendered their products due to the declining interest rate environment. A decrease of \$9.4 million was primarily due to intra-segment eliminations. In addition, a \$2.6 million decrease was primarily a result of lower commission fee revenues from sales of third-party mutual funds and lower mutual fund fee revenues reflecting a decrease in mutual fund assets under management. The decreases were partially offset by an increase of \$14.4 million related to Principal Capital Management, primarily the result of revenues attributable to commercial mortgage-backed securitizations.

Net investment income increased \$58.2 million, or 5%, to \$1,207.4 million for the six months ended June 30, 2001, from \$1,149.2 million for the six months ended June 30, 2000. The increase was primarily due to a \$2,327.8 million, or 8%, increase in average invested assets and cash for the segment. The yield on average invested assets and cash was 7.3% for the six months ended June 30, 2001, compared to 7.5% for the six months ended June 30, 2000, reflecting an increase in cash and cash equivalents, which earns lower yields than invested assets.

Benefits, claims and settlement expenses, including dividends to policyholders, increased \$150.1 million, or 14%, to \$1,242.9 million for the six months ended June 30, 2001, from \$1,092.8 million for the six months ended June 30, 2000. An increase of \$143.0 million in our pension full-service payout business primarily reflected the increase in reserves resulting from an increase in sales of single premium group annuities with life contingencies. An additional \$41.8 million increase related to our pension investment-only business was primarily due to an increase in interest credited due to growth in our investment-only business. Partially offsetting the increases was a \$38.8 million decrease in our pension

full-service accumulation business reflecting a decrease in interest credited, primarily a result of a decrease in average crediting rates.

Operating expenses increased \$40.1 million, or 11%, to \$399.5 million for the six months ended June 30, 2001, from \$359.4 million for the six months ended June 30, 2000. An increase of \$23.9 million related to our pension business was primarily due to an increase in compensation costs resulting from growth in operations and an increase related to the net impact of capitalization and amortization of deferred policy acquisition costs. An increase of \$15.3 million for Principal Bank was primarily related to growth in bank operations. Additionally, an increase of \$13.8 million related to Principal Capital Management was primarily the result of an increase in compensation costs resulting from growth in operations. The increases were partially offset by a \$9.4 million decrease resulting from intra-segment eliminations and a \$4.3 million decrease in mutual fund commissions.

Income taxes decreased \$32.3 million, or 45%, to \$38.9 million for the six months ended June 30, 2001, from \$71.2 million for the six months ended June 30, 2000. The effective income tax rate for this segment was 18% for the six months ended June 30, 2001, and 29% for the six months ended June 30, 2000. The effective income tax rates for the six months ended June 30, 2001 and 2000 were lower than the corporate income tax rate of 35%, primarily due to income tax deductions allowed for corporate dividends received, for which the estimated benefit recognition rate increased during the six months ended June 30, 2001, compared to the six months ended June 30, 2000, and other tax-exempt income.

As a result of the foregoing factors, operating earnings decreased \$0.4 million to \$176.9 million for the six months ended June 30, 2001, from \$177.3 million for the six months ended June 30, 2000.

Net realized capital losses, as adjusted, increased \$5.7 million, or 16%, to \$40.8 million for the six months ended June 30, 2001, from \$35.1 million for the six months ended June 30, 2000. The increase reflects the current period impact of SFAS 133 for derivatives, losses resulting from the permanent impairment of certain equity and fixed maturity securities and fewer real estate sales in the six months ended June 30, 2001, compared to the six months ended June 30, 2000. The increases were partially offset by the positive effects of a change in the mortgage loan valuation allowance, primarily reflecting the decrease in the amount invested in commercial mortgage loans. In addition, there was a decrease in losses related to sales of fixed maturity securities, reflecting a decrease in portfolio activity in 2001.

As a result of the foregoing factors and the inclusion of non-recurring items for the six months ended June 30, 2001, net income decreased \$16.9 million, or 12%, to \$125.3 million for the six months ended June 30, 2001, from \$142.2 million for the six months ended June 30, 2000. Non-recurring items for the six months ended June 30, 2001, had a negative impact on net income of \$10.8 million, net of tax, due to the cumulative effect of accounting change, net of income taxes, related to our implementation of SFAS 133, as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items."

#### YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

Premiums and other considerations decreased \$41.3 million, or 7%, to \$525.4 million in 2000, from \$566.7 million in 1999. The decrease was primarily due to a \$43.3 million decrease in premiums from single premium group annuities with life contingencies, which are typically used to fund defined benefit pension plan terminations. The premium income we receive from these contracts fluctuates due to the variability in the number and size of pension plan terminations in the market and our ability to attract new sales. This decrease was partially offset by a \$2.0 million increase related to increased sales of our single premium individual annuities with life contingencies.

Fees and other revenues increased \$88.4 million, or 14%, to \$704.6 million in 2000, from \$616.2 million in 1999. The increase was primarily related to a \$74.2 million increase in administrative fee revenues for pension products and services. The increase in administrative fee revenues reflected an increase in the amortization of front-end fee revenues, a result of a change in our assumptions related to amortization of deferred policy acquisition costs attributable to pension products. We also received higher fee revenues from surrender charges and pension customer-directed investment transfers, reflecting the higher interest rate environment and increased customer account activity. The increase in fee revenues was also due in part to growth in assets under management related to our pension products in 1999. An increase of \$13.0 million was primarily due to investment management fee revenues from our mutual fund business and commission fee revenues related to sales of third-party mutual funds. An increase of \$5.6 million in individual annuity fees, primarily a result of growth in separate account assets related to individual annuity products, also contributed to the segment increase. The increase in fees and other revenues was partially offset by a \$5.6 million decrease in fee revenues related to Principal Capital Management, primarily a result of a decrease in proceeds related to commercial mortgage-backed securitization transactions.

Net investment income increased \$14.2 million, or 1%, to \$2,303.9 million in 2000, from \$2,289.7 million in 1999. The increase was primarily due to a \$1,561.6 million, or 5%, increase in average invested assets and cash for the segment. The yield on average invested assets and cash was 7.3% in 2000, compared to 7.6% in 1999, due to a decrease in interest credited on assets backing allocated capital. The decrease in interest credited was partially offset by higher interest rates on fixed income investments backing product liabilities.

Benefits, claims and settlement expenses, including dividends to policyholders, decreased \$29.1 million, or 1%, to \$2,315.2 million in 2000, from \$2,344.3 million in 1999. A decrease of \$26.7 million in benefits and reserve changes, and a \$4.5 million decrease in dividends to policyholders were both related to our full-service pension accumulation products, reflecting the decrease in our block of pension experience rated business and an increase in our guaranteed business. An additional \$21.4 million decrease was attributable to decreased sales of single premium group annuities with life contingencies. Partially offsetting these decreases was a \$19.5 million increase related to our investment-only business, primarily reflecting an increase in interest credited due to the growth in our investment-only business. An additional \$3.8 million increase was primarily related to an increase in interest credited on individual fixed annuities and the fixed component of variable annuities, a result of higher interest crediting rates during 2000.

Operating expenses increased \$114.6 million, or 18%, to \$740.9 million in 2000, from \$626.3 million in 1999. An increase of \$57.3 million was primarily due to a change in our assumptions related to amortization of deferred policy acquisition costs attributable to pension products. An additional \$28.7 million increase was primarily related to an increase in pension salary and incentive compensation costs and other pension administrative costs. Operating expenses also increased \$9.7 million for our mutual fund business, primarily the result of increased sales of third-party mutual funds and also due to other mutual fund operating expenses. An \$8.3 million increase in operating expenses related to our individual annuity business was primarily due to an increase in amortization of deferred policy acquisition costs. Additionally, a \$6.5 million increase in operating expenses for Principal Capital Management was primarily related to an increase in incentive compensation costs.

Income taxes decreased \$24.2 million, or 17%, to \$121.2 million in 2000, from \$145.4 million in 1999. The effective income tax rate for this segment was 25% in 2000, and 29% in 1999. The effective tax rates were lower than the corporate income tax rate of 35%, primarily due to income tax deductions allowed for corporate dividends received and other tax-exempt income.

As a result of the foregoing factors, operating earnings were \$356.6 million in both 2000 and 1999.

Net realized capital losses, as adjusted, increased to \$35.9 million in 2000, from \$35.4 million in 1999. This segment recognized net realized capital losses consistent with our change in investment philosophy, which increased portfolio activity. We repositioned the investment portfolio to maximize operating investment returns by selling lower yielding fixed income securities to allow for reinvestment in higher yielding fixed income securities. This repositioning of the portfolio generated net realized capital losses.

As a result of the foregoing factors, net income decreased to \$320.7 million in 2000, from \$321.2 million in 1999.

#### YEAR ENDED DECEMBER 31, 1999 COMPARED TO YEAR ENDED DECEMBER 31, 1998

Premiums and other considerations increased \$285.0 million, or 101%, to \$566.7 million in 1999 from \$281.7 million in 1998. The increase was primarily due to a \$279.9 million increase in premiums for single premium group annuities with life contingencies, which are typically used to fund defined benefit pension plan terminations. The premium income we receive from these contracts fluctuates due to the variability in the number and size of defined benefit pension plan terminations in the market and our ability to attract new sales. The increase in premiums and other considerations was also due to a \$5.1 million increase related to increased sales of single premium individual annuities with life contingencies.

Fees and other revenues increased \$165.4 million, or 37%, to \$616.2 million in 1999, from \$450.8 million in 1998. The increase was primarily contributed by our U.S. asset management operations, as we included Principal Capital Management in this segment at the beginning of 1999. Fees and other revenues contributed in 1999 by Principal Capital Management were \$74.6 million. In addition, an increase of \$71.8 million in fees and other revenues from our pension products contributed to the increase, as a result of growth in assets under management, which benefited from strong equity market performance in 1999 and an increase in net deposits received from customers, particularly in early 1999. The increase in fees and other revenues was also due to an \$11.9 million increase in mutual fund fee revenues, primarily due to an increase in assets under management in our mutual fund business. The growth in assets under management related to our individual annuity products also contributed to a \$6.9 million increase in fees and other revenues, which reflected the increase in new deposits related to individual variable annuity sales and strong market performance.

Net investment income increased \$89.1 million, or 4%, to \$2,289.7 million in 1999, from \$2,200.6 million in 1998. The increase was primarily due to a \$858.6 million, or 3%, increase in average invested assets and cash for the segment. The yield on average invested assets and cash was 7.6% in 1999 and 7.5% in 1998.

Benefits, claims and settlement expenses, including dividends to policyholders, increased \$324.8 million, or 16%, to \$2,344.3 million in 1999, from \$2,019.5 million in 1998. An increase of \$227.6 million was primarily due to a larger block of single premium group annuities with life contingencies. Additionally, the growth in our block of group annuities caused a \$93.6 million increase in interest credited to guaranteed business. In addition, a \$10.3 million increase in dividends to policyholders was a reflection of lower dividends in 1998, a result of several large group annuity contracts that renewed in the form of non-participating contracts in 1998. These increases were partially offset by a \$9.9 million



decrease, primarily due to a decrease in interest credited on individual annuities, the result of a smaller block of single premium individual annuities with life contingencies reflecting terminations that exceeded new sales. The decrease in interest credited was also due to lower interest crediting rates in 1999 compared to 1998.

Operating expenses increased \$34.0 million, or 6%, to \$626.3 million in 1999, from \$592.3 million in 1998. The increase was primarily due to higher operating expenses from our U.S. asset management operations, related to Principal Capital Management, which was included in this segment at the beginning of 1999. Operating expenses attributable to Principal Capital Management were \$68.9 million. The increase was also due to a \$7.4 million increase in operating expenses, primarily related to growth in our individual annuity business, reflected by increases in general expenses, taxes, licenses and fees and amortization of deferred policy acquisition costs. Additionally, we experienced an \$8.4 million increase, primarily attributable to increased commissions and other general expenses related to our mutual fund business. The increases were partially offset by a \$35.6 million decrease in operating expenses related to our pension products and services, which reflect higher expenses in 1998 related to the costs of implementing new retirement plan processing technology. In addition, a \$16.6 million decrease was due to a write-down of goodwill in 1998, reflecting continued operating losses and significantly reduced cash flow forecasts of Trust Consultants, Inc., a pension administration subsidiary.

Income taxes increased \$62.5 million, or 75%, to \$145.4 million in 1999 from \$82.9 million in 1998. The effective income tax rate for this segment was 29% in 1999 and 26% in 1998, compared to the U.S. corporate income tax rate of 35%. The effective income tax rate was lower than the corporate income tax rate in 1999 and 1998, due to tax exempt income related primarily to dividends received deductions. Although tax exempt income for the segment increased over 1998 levels, the increase in the effective tax rate for 1999 was due to the increase in taxable operating earnings for the segment.

As a result of the foregoing factors, operating earnings increased \$118.2 million, or 50%, to \$356.6 million in 1999, from \$238.4 million in 1998.

Net realized capital gains, as adjusted, decreased \$50.1 million to net realized capital losses of \$35.4 million in 1999, from \$14.7 million of net realized capital gains in 1998. This segment recognized net realized capital losses consistent with our change in investment philosophy, which increased portfolio activity. Specifically, we repositioned the investment portfolio to maximize operating investment returns by selling lower yielding invested assets to allow for reinvestment in higher yielding investments. This repositioning of the portfolio generated net realized capital losses.

As a result of the foregoing factors and the inclusion of non-recurring items in 1998, net income increased \$44.2 million, or 16%, to \$321.2 million in 1999, from \$277.0 million in 1998. In 1998, net income for this segment included non-recurring items totaling \$23.9 million, net of tax, related to a release of a tax reserve, as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items".

## INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION SEGMENT

The table below presents certain summary financial data relating to the International Asset Management and Accumulation segment for the periods indicated:

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
	----- (\$ IN MILLIONS) -----				
<b>OPERATING EARNINGS DATA:</b>					
Operating revenues(1):					
Premiums and other considerations.....	\$110.0	\$108.9	\$220.5	\$179.9	\$147.1
Fees and other revenues.....	139.5	153.0	305.2	105.6	28.1
Net investment income.....	60.6	47.6	105.0	94.1	47.9
	-----	-----	-----	-----	-----
Total operating revenues.....	310.1	309.5	630.7	379.6	223.1
Expenses:					
Benefits, claims and settlement expenses.....	139.6	126.9	262.2	210.1	165.2
Operating expenses.....	177.5	184.1	372.3	212.1	101.2
	-----	-----	-----	-----	-----
Total expenses.....	317.1	311.0	634.5	422.2	266.4
	-----	-----	-----	-----	-----
Pre-tax operating loss.....	(7.0)	(1.5)	(3.8)	(42.6)	(43.3)
Income taxes (benefits).....	(2.3)	2.2	4.7	(4.2)	(7.9)
	-----	-----	-----	-----	-----
Operating loss.....	(4.7)	(3.7)	(8.5)	(38.4)	(35.4)
	-----	-----	-----	-----	-----
Net realized capital gains (losses), as adjusted.....	(21.2)	3.5	1.4	7.7	12.0
Non-recurring items.....	--	--	--	--	13.3
	-----	-----	-----	-----	-----
<b>GAAP REPORTED:</b>					
Net loss.....	\$(25.9)	\$ (0.2)	\$ (7.1)	\$(30.7)	\$(10.1)
	=====	=====	=====	=====	=====
<b>OTHER DATA:</b>					
Operating earnings (loss):					
Principal International.....	\$ 1.1	\$ (9.6)	\$(14.8)	(33.6)	\$(35.4)
BT Financial Group.....	(5.8)	5.9	6.3	(4.8)	--
Operating earnings (loss) before amortization of goodwill and other intangibles:					
Principal International.....	\$ 5.8	\$ (4.7)	\$(3.9)	\$(31.3)	\$(28.5)
BT Financial Group.....	9.0	19.2	32.4	6.7	--

(1) Excludes net realized capital gains (losses) and their impact on recognition of front-end fee revenues.

## SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

Premiums and other considerations increased \$1.1 million, or 1%, to \$110.0 million for the six months ended June 30, 2001, from \$108.9 million for the six months ended June 30, 2000. An increase of \$23.5 million in Mexico was primarily the result of increased sales of single premium annuities with life contingencies, primarily generated as a result of additional agents. In addition, a \$4.8 million increase in Argentina was primarily the result of increased sales of single premium annuities with life contingencies and group life insurance products. The increases were partially offset by the loss of \$24.6 million of premiums and other considerations due to the February 2001 divestiture of our operations in Spain. In addition, a \$2.9 million decrease was primarily due to the weakening of the Chilean peso versus the U.S. dollar.

Fees and other revenues decreased \$13.5 million, or 9%, to \$139.5 million for the six months ended June 30, 2001, from \$153.0 million for the six months ended June 30, 2000. The decrease was primarily related to a \$21.8 million decrease of fee revenues contributed by BT Financial Group, primarily a result of the weakening of the Australian dollar versus the U.S. dollar and, to a lesser extent, due to declining assets under management for the six months ended June 30, 2001. The decrease was partially offset by an \$8.1 million increase in Principal International fee revenues, a result of assets under management growth in Mexico and Argentina and deposits growth in Hong Kong resulting from sales to plans established under the new Mandatory Provident Fund, which started in December 2000.

Net investment income increased \$13.0 million, or 27%, to \$60.6 million for the six months ended June 30, 2001, from \$47.6 million for the six months ended June 30, 2000. The increase was primarily attributable to a \$19.9 million increase from Principal International related to a 14% increase in average invested assets and an increase in investment yields. The yield on average invested assets and cash was 9.7% for the six months ended June 30, 2001,



compared to 6.9% for the six months ended June 30, 2000. The increase in investment yields was partially due to the impact of inflation adjustments in Chile, which was offset by a corresponding increase in reserve changes. The increase in net investment income was partially offset by the \$4.3 million loss of net investment income resulting from the divestiture of our operations in Spain. In addition, a decrease of \$1.5 million of equity method net investment income was related to our pro rata share of net loss of ING/Principal Pensions Co., Ltd., a pension company in Japan in which we acquired a minority interest in January 2000. The increase was also partially offset by a \$0.6 million decrease related to the operations of BT Financial Group.

Benefits, claims and settlement expenses increased \$12.7 million, or 10%, to \$139.6 million for the six months ended June 30, 2001, from \$126.9 million for the six months ended June 30, 2000. The increase was primarily due to an increase in reserve changes and policy and contract benefit payments of \$23.9 million in Mexico and \$2.8 million in Argentina, the result of increased sales of single premium annuities with life contingencies. The increase was also related to a \$13.7 million increase in Chile, primarily related to an increase in reserve changes to reflect the impact of inflation adjustments. The increases were partially offset by the loss of \$27.6 million of benefits, claims and settlement expenses resulting from the divestiture of our operations in Spain.

Operating expenses decreased \$6.6 million, or 4%, to \$177.5 million for the six months ended June 30, 2001, from \$184.1 million for the six months ended June 30, 2000. The decrease was primarily due to a \$5.1 million decrease of operating expenses incurred by BT Financial Group, primarily resulting from the weakening of the Australian dollar versus the U.S. dollar. The decrease was partially offset by an increase in compensation costs resulting primarily from annual pay increases and an increase in amortization of goodwill and other intangibles. The decrease was also due to the loss of \$3.3 million of operating expenses resulting from the divestiture of our operations in Spain. In addition, a \$3.0 million decrease was primarily due to the weakening of the Chilean peso and the Indonesian rupiah versus the U.S. dollar. The decreases were partially offset by a \$4.6 million increase in Mexico, primarily attributable to commissions and compensation resulting from increased sales.

Income tax expense (benefits) decreased \$4.5 million to a \$2.3 million income tax benefit for the six months ended June 30, 2001, from \$2.2 million of income tax expense for the six months ended June 30, 2000. The decrease was primarily due to a decrease in pre-tax operating earnings from BT Financial Group.

As a result of the foregoing factors, operating loss increased \$1.0 million, or 27%, to \$4.7 million for the six months ended June 30, 2001, from \$3.7 million for the six months ended June 30, 2000.

Net realized capital gains (losses), as adjusted, decreased \$24.7 million to \$21.2 million of net realized capital losses for the six months ended June 30, 2001, from \$3.5 million of net realized capital gains for the six months ended June 30, 2000. The decrease was primarily due to a \$21.0 million after-tax net realized capital loss on the February 2001 sale of our operations in Spain. In addition, a \$4.1 million decrease was related to net realized capital gains from our operations in Spain for the six months ended June 30, 2000.

As a result of the foregoing factors, net loss increased \$25.7 million to \$25.9 million for the six months ended June 30, 2001, from \$0.2 million for the six months ended June 30, 2000.

#### YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

Premiums and other considerations increased \$40.6 million, or 23%, to \$220.5 million in 2000, from \$179.9 million in 1999. Increases of \$16.9 million in Mexico, \$16.7 million in Argentina and \$5.9 million in Chile were primarily a result of increased sales of single premium annuities with life contingencies. The increased sales in Mexico were primarily a result of sales by Principal Pensiones, S.A. de C.V., an annuity company we established in July 1999. The increased sales in Argentina primarily resulted from sales by an annuity company we established in August 1999.

Fees and other revenues increased \$199.6 million to \$305.2 million in 2000, from \$105.6 million in 1999. The increase was primarily related to a \$180.2 million increase resulting from the contribution of fee revenues by BT Financial Group, which we acquired in August 1999. In addition, an \$8.1 million increase was primarily due to lower fees and other revenues recognized in 1999 related to El Roble in Chile. An additional \$6.5 million increase was primarily attributable to higher fee revenues from administering retirement funds in Mexico, due to the implementation of a more attractive pricing structure for our customers, which also resulted in increased retention of existing accounts and an increased number of covered lives.

Net investment income increased \$10.9 million, or 12%, to \$105.0 million in 2000, from \$94.1 million in 1999. An \$11.3 million increase was primarily attributable to an increase in average invested assets in Principal International. In addition, an \$11.2 million increase resulted from our equity method investment gains related to our pro rata share of net income, excluding the effect of goodwill amortization, of BrasilPrev Previdencia Privada S.A., a pension company in Brazil in which we acquired a minority interest in October 1999. The increases were partially offset by an \$8.7 million decrease related to the inclusion of BT Financial Group, primarily related to its margin lending business. The margin lending business was securitized in late 1999, which resulted in a shift of income generation from net investment income to fee revenues in 2000. The increases were also partially offset by a \$3.1 million equity method investment



loss related to our pro rata share of net loss of ING/Principal Pensions Co., Ltd., a pension company in Japan in which we acquired a minority interest in January 2000.

Benefits, claims and settlement expenses increased \$52.1 million, or 25%, to \$262.2 million in 2000, from \$210.1 million in 1999. The increase was primarily due to an increase in reserve changes and policy and contract benefit payments of \$18.5 million in Mexico and \$18.4 million in Argentina, the result of increased sales of single premium annuities with life contingencies. In addition, a \$13.4 million increase in reserve changes and policy and contract benefit payments in Chile primarily resulted from the increased sales of annuity products and the implementation of a new reserve calculation method to refine reserve calculations.

Operating expenses increased \$160.2 million, or 76%, to \$372.3 million in 2000, from \$212.1 million in 1999. The increase was primarily due to a \$151.1 million increase resulting from the inclusion of operating expenses incurred by BT Financial Group, including a \$23.3 million increase in amortization of goodwill and other intangibles. The increase also included \$6.0 million of amortization of goodwill and present value of future profits related to BrasilPrev, which we acquired in October 1999.

Income tax expense (benefits) increased \$8.9 million to \$4.7 million of tax expense in 2000, from a \$4.2 million tax benefit in 1999. The increase was primarily due to \$9.1 million of income tax expense related to an increase in pre-tax operating earnings from BT Financial Group.

As a result of the foregoing factors, operating loss decreased \$29.9 million, or 78%, to \$8.5 million in 2000, from \$38.4 million in 1999.

Net realized capital gains, as adjusted, decreased \$6.3 million, or 82%, to \$1.4 million in 2000, from \$7.7 million in 1999. The decrease was primarily due to a \$4.7 million decrease in net realized capital gains in Principal International, resulting from repositioning of investment portfolios to better match long-term liabilities and assets in 1999. In addition, net realized capital gains, as adjusted, in 1999 included a \$1.7 million gain on the sale of minority interest in a capital management company, which was sold following the acquisition of BT Financial Group.

As a result of the foregoing factors, net loss decreased \$23.6 million, or 77%, to \$7.1 million in 2000, from \$30.7 million in 1999.

#### YEAR ENDED DECEMBER 31, 1999 COMPARED TO YEAR ENDED DECEMBER 31, 1998

Premiums and other considerations increased \$32.8 million, or 22%, to \$179.9 million in 1999, from \$147.1 million in 1998. An increase of \$14.2 million was primarily due to increased premiums in Chile related to El Roble, which we acquired in July 1998. A \$6.9 million increase related primarily to sales of single premium annuities with life contingencies by a newly formed annuity company, Principal Pensiones, S.A. de C.V., in Mexico in July 1999. Premiums and other considerations in Spain increased \$6.7 million, primarily due to increased sales of single premium group annuities with life contingencies. Changes to the distribution within Principal Mexico Compania de Seguros S.A. de C.V., and new business generated as a result of name recognition of our two Mexican companies, Principal Afore S.A. de C.V. and Principal Pensiones S.A. de C.V., helped contribute to an increase in group insurance premiums of \$2.2 million. In addition, premiums of \$1.8 million were generated in 1999 related to a new lump sum individual annuity product with life contingencies in Argentina.

Fees and other revenues increased \$77.5 million to \$105.6 million in 1999, from \$28.1 million in 1998. The increase was primarily related to BT Financial Group, which contributed \$95.5 million of fees and other revenues in 1999. This increase was partially offset by a \$9.7 million decrease relating to El Roble, and the loss of \$6.5 million of fees due to our 1998 divestiture of a pension subsidiary in Argentina. The divestiture resulted from our decision to discontinue selling products related to the state-mandated retirement plan, which we determined did not generate adequate returns.

Net investment income increased \$46.2 million, or 96%, to \$94.1 million in 1999, from \$47.9 million in 1998. The increase was primarily due to \$19.7 million of increased net investment income related to our 1998 acquisition of El Roble. BT Financial Group generated \$18.3 million of net investment income in 1999. An additional \$6.7 million of the increase related to investment income received in 1999 on an international mutual fund in Chile, which had generated a loss in 1998. This mutual fund was classified as a trading security in 1998 and 1999, but has been classified as available-for-sale since January 1, 2000. Related gains and losses will be recognized in equity rather than net investment income.

Benefits, claims and settlement expenses increased \$44.9 million, or 27%, to \$210.1 million in 1999, from \$165.2 million in 1998. The increase was primarily due to \$27.0 million of additional expenses related to El Roble. In addition, an increase in changes in reserves of \$7.8 million in Spain was due primarily to increased sales of single premium group annuities with life contingencies. In addition, the increase was also due to \$6.9 million of expenses related to Principal Pensiones, which we formed in 1999 in Mexico. The increase was also due to a \$1.0 million increase in change in reserves in Mexico, as a result of increased sales of group life insurance products.

Operating expenses increased \$110.9 million, or 110%, to \$212.1 million in 1999, from \$101.2 million in 1998. The increase was primarily related to BT Financial Group, which contributed \$117.3 million of operating expenses in 1999,

including \$13.7 million amortization of goodwill and other intangibles. The increase was partially offset by a \$5.3 million decrease in expenses in Argentina, primarily related to the subsidiary we sold in 1998, and reductions in sales force and staff levels in our remaining operations in Argentina.

Income tax benefits decreased \$3.7 million, or 47%, to \$4.2 million in 1999, from \$7.9 million in 1998. A decrease in income tax benefits of \$2.4 million was primarily associated with deferred tax assets related to income tax benefits in our international asset accumulation operations that were not recognized due to loss carryforwards we determined would not be utilized. The decrease was also due to \$1.3 million of income tax expense related to BT Financial Group, which we acquired in August 1999.

As a result of the foregoing factors, operating loss increased \$3.0 million, or 8%, to \$38.4 million in 1999, from \$35.4 million in 1998.

Net realized capital gains, as adjusted, decreased \$4.3 million, or 36%, to \$7.7 million in 1999, from \$12.0 million in 1998. Net realized capital gains decreased \$6.0 million, primarily because 1998 included the gain on the sale of the pension subsidiary in Argentina in 1998, as previously discussed. The decrease was offset by \$1.7 million of net realized capital gains contributed by BT Financial Group.

As a result of the foregoing factors and the inclusion of non-recurring items in 1998, net loss increased \$20.6 million to \$30.7 million in 1999, from \$10.1 million in 1998. In 1998, our net loss included the positive effects of \$13.3 million, net of tax, of non-recurring items related to accounting changes by Principal International.

#### LIFE AND HEALTH INSURANCE SEGMENT

The table below presents certain summary financial data relating to the Life and Health Insurance segment for the periods indicated:

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
	(\$ IN MILLIONS)				
<b>OPERATING EARNINGS DATA:</b>					
<b>Operating Revenues(1):</b>					
Premiums and other considerations.....	\$1,515.3	\$1,683.0	\$3,250.5	\$3,190.6	\$3,126.6
Fees and other revenues.....	128.9	105.0	230.0	180.2	146.7
Net investment income.....	334.0	312.7	642.1	614.7	619.8
Total operating revenues.....	1,978.2	2,100.7	4,122.6	3,985.5	3,893.1
<b>Expenses:</b>					
Benefits, claims and settlement expenses.....	1,260.4	1,380.0	2,659.4	2,714.9	2,605.3
Dividends to policyholders.....	158.3	153.9	308.1	295.6	300.0
Operating expenses.....	422.6	440.8	913.6	872.0	892.4
Total expenses.....	1,841.3	1,974.7	3,881.1	3,882.5	3,797.7
Pre-tax operating earnings.....	136.9	126.0	241.5	103.0	95.4
Income taxes.....	46.0	40.0	79.2	12.3	45.4
Operating earnings.....	90.9	86.0	162.3	90.7	50.0
Net realized capital gains (losses), as adjusted...	(4.7)	50.1	47.3	10.1	1.9
Non-recurring items.....	0.1	--	--	--	60.1
<b>GAAP REPORTED:</b>					
Net income.....	\$ 86.3	\$ 136.1	\$ 209.6	\$ 100.8	\$ 112.0
<b>OTHER DATA:</b>					
<b>Premiums and other considerations:</b>					
Group life and health insurance.....	\$1,090.8	\$1,257.3	\$2,403.5	\$2,345.2	\$2,278.8
Individual life and disability insurance.....	424.5	425.7	847.0	845.4	847.8
<b>Incurring loss ratios(2):</b>					
Group life insurance.....	69%	71%	70%	71%	79%
Group disability insurance.....	86	100	85	80	102
Group medical and group Medicare supplement insurance(3).....	82	82	83	90	85
Group dental and vision insurance.....	77	79	76	77	77

(1) Excludes net realized capital gains (losses) and their impact on recognition of front-end fee revenues.

(2) Ratios exclude the impact of the change in experience related reserves for all time periods, to reflect underlying claim experience.

(3) Ratios exclude group Medicare supplement insurance after July 1, 2000, the date at which group Medicare supplement insurance was 100% reinsured.

#### SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

Premiums and other considerations decreased \$167.7 million, or 10%, to \$1,515.3 million for the six months ended June 30, 2001, from \$1,683.0 million for the six months ended June 30, 2000. Group Medicare supplement insurance premium decreased \$98.5 million, resulting from our decision to reinsure 100% of this business effective July 1, 2000. Large premium rate increases in 2000 led to increased lapses and lower sales of group medical insurance, which resulted in a \$59.5 million decrease in premiums. Group life insurance premium decreased \$26.4 million, primarily due to the loss of two large customers and an overall increase in lapses associated with lapses of group medical coverages. The decreases were partially offset by a \$14.4 million increase in group dental insurance premium due to increases in dental premium rates.

Fees and other revenues increased \$23.9 million, or 23%, to \$128.9 million for the six months ended June 30, 2001, from \$105.0 million for the six months ended June 30, 2000. Fee revenues from our group fee-for-service business increased \$11.5 million, primarily due to increases in fee rates and growth in that business. Fee revenues from individual interest-sensitive life insurance products increased \$10.2 million, a result of growth in that business. The growth reflected a continued shift in customer preference from individual traditional life insurance products to individual universal life and individual variable universal life insurance products. Individual traditional life insurance and other life insurance fee revenues increased \$1.6 million, primarily related to growth in reinsurance fee revenues.

Net investment income increased \$21.3 million, or 7%, to \$334.0 million for the six months ended June 30, 2001, from \$312.7 million for the six months ended June 30, 2000. The increase was primarily due to a \$339.2 million, or 4%, increase in average invested assets and cash for the segment. Net investment income also increased due to an increase in average investment yields for the segment. The yield on average invested assets and cash was 7.5% for the six months ended June 30, 2001, compared to 7.3% for the six months ended June 30, 2000, reflecting higher interest yields on fixed income securities backing product liabilities.

Benefits, claims and settlement expenses decreased \$119.6 million, or 9%, to \$1,260.4 million for the six months ended June 30, 2001, from \$1,380.0 million for the six months ended June 30, 2000. Group Medicare supplement insurance benefits, claims and settlement expenses decreased \$97.0 million, resulting from our decision to reinsure 100% of this business effective July 1, 2000. Group life insurance benefits, claims and settlement expenses decreased \$23.4 million due to lower mortality experience, the loss of two large customers and an overall decline in business. Group medical insurance business continued to decline, resulting in an additional decrease in benefits, claims and settlement expenses.

Dividends to policyholders increased \$4.4 million, or 3%, to \$158.3 million for the six months ended June 30, 2001, from \$153.9 million for the six months ended June 30, 2000. The increase was due to increased dividends on traditional individual life insurance products, a result of increases in the cash value of the policies.

Operating expenses decreased \$18.2 million, or 4%, to \$422.6 million for the six months ended June 30, 2001, from \$440.8 million for the six months ended June 30, 2000. Group life and health insurance operating expenses decreased \$27.3 million primarily due to a decrease in commissions resulting from our decision to reinsure 100% of our group Medicare supplement insurance business effective July 1, 2000, and due to expense management in response to an overall decline in business. The decrease was offset by a \$9.1 million increase in individual life and health operating expenses, primarily attributable to growth in our individual disability insurance business and due to higher amortization of deferred policy acquisition costs related to individual disability and individual life insurance.

Income taxes increased \$6.0 million, or 15%, to \$46.0 million for the six months ended June 30, 2001, from \$40.0 million for the six months ended June 30, 2000. The effective income tax rate for this segment was 34% for the six months ended June 30, 2001, and 32% for the six months ended June 30, 2000. The effective income tax rate for the six months ended June 30, 2001, was lower than the corporate income tax rate of 35% primarily due to tax-exempt income. The effective tax rate for the six months ended June 30, 2000 was lower than the corporate income tax rate of 35%, primarily due to tax exempt income and a reduction in a tax reserve as a result of a favorable IRS audit event.

As a result of the foregoing factors, operating earnings increased \$4.9 million, or 6%, to \$90.9 million for the six months ended June 30, 2001, from \$86.0 million for the six months ended June 30, 2000.

Net realized capital gains (losses), as adjusted, decreased \$54.8 million to a \$4.7 million net realized capital loss for the six months ended June 30, 2001, from a \$50.1 million net realized capital gain for the six months ended June 30, 2000. The decrease primarily related to the sale of our investment in United Payors and United Providers. In 2000, we sold our remaining investment and realized an after-tax capital gain of \$58.9 million. The decrease was also due to losses from permanent impairments of fixed maturity securities during the six months ended June 30, 2001. The



decreases were partially offset by the positive effects of a change in the mortgage loan valuation allowance, primarily reflecting a decrease in the amount invested in commercial mortgage loans.

As a result of the foregoing factors and the inclusion of non-recurring items for the six months ended June 30, 2001, net income decreased \$49.8 million, or 37%, to \$86.3 million for the six months ended June 30, 2001, from \$136.1 million for the six months ended June 30, 2000. Non-recurring items for the six months ended June 30, 2001, had a positive impact on net income of \$0.1 million, net of tax, due to the cumulative effect of accounting change, net of income taxes, related to our implementation of SFAS 133, as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items."

#### YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

Premiums and other considerations increased \$59.9 million, or 2%, to \$3,250.5 million in 2000, from \$3,190.6 million in 1999. Group dental insurance premiums increased \$72.3 million, primarily resulting from increased sales of group dental insurance products. Group medical premiums increased \$38.3 million, primarily related to an increase in the premium base due to increased sales in late 1999, and significant group medical premium rate increases. Also contributing to the increase was a \$9.6 million increase in individual disability insurance premiums due to continued growth in sales. Group disability insurance premiums increased \$8.4 million due to an increase in long-term disability covered members and an increase in short-term disability premium per member. These increases were partially offset by a \$66.2 million decrease in group Medicare supplement premium, resulting from our decision to cease new sales of group Medicare supplement insurance in January 2000 and our decision to reinsure 100% of this business effective July 1, 2000.

Fees and other revenues increased \$49.8 million, or 28%, to \$230.0 million in 2000, from \$180.2 million in 1999. Fee revenues from individual interest-sensitive life insurance products increased \$27.4 million, a result of growth in that block of business. The growth reflects a continued shift in customer preference from individual traditional life insurance products to individual universal life and individual variable life insurance products. Fee revenues from our group fee-for-service business increased \$20.3 million, primarily due to increases in members and fees.

Net investment income increased \$27.4 million, or 4%, to \$642.1 million in 2000, from \$614.7 million in 1999. The increase was primarily due to a \$483.9 million, or 6%, increase in average invested assets and cash for the segment. The increase in net investment income due to asset growth was partially offset by a decrease in average investment yields for the segment. The yield on average invested assets and cash was 7.4% in 2000, compared to 7.5% in 1999, due to a decrease in interest credited on assets backing allocated capital. The decrease in interest credited was partially offset by higher interest rates on fixed income investments backing product liabilities.

Benefits, claims and settlement expenses decreased \$55.5 million, or 2%, to \$2,659.4 million in 2000, from \$2,714.9 million in 1999. Group medical insurance benefits claims and settlement expenses decreased \$108.6 million, primarily resulting from the release of claim reserves established in 1999. The claim reserves were established in 1999 as a result of poor claim experience during the year and an expectation that claims would continue to increase through the second quarter of 2000. This decrease was partially offset by an increase in claims due to rising medical costs. Benefits, claims and settlement expenses also decreased \$102.8 million for group Medicare supplement insurance, as a result of our reinsuring this business effective July 1, 2000, improved claim experience during the first half of the year and the release of reserves established in 1999, for the same reasons previously described for our group medical business. These decreases were partially offset by a \$56.1 million increase in group dental benefits, claims and settlement expenses, primarily due to growth in that block of business. Individual disability insurance claims and reserves increased \$49.5 million, primarily due to less favorable morbidity experience and related increases in reserves for claims and incurred but not reported claims. Individual interest-sensitive life insurance benefits and claims increased \$40.2 million, primarily due to an increase in both interest credited and mortality costs, primarily resulting from growth in the block of business and reserve adjustments. Group disability claims and reserves increased \$9.5 million, primarily a result of less favorable morbidity experience and an increase in covered members.

Dividends to policyholders increased \$12.5 million, or 4%, to \$308.1 million in 2000, from \$295.6 million in 1999. The increase was due to increased dividends on traditional individual life insurance products, a result of increases in the cash values of the policies.

Operating expenses increased \$41.6 million, or 5%, to \$913.6 million in 2000, from \$872.0 million in 1999. Group life and health insurance operating expenses increased \$26.0 million, primarily due to expenses related to our group Medicare supplement business, and a write-down of goodwill related to group Medicare supplement insurance. Group life and health insurance operating expenses also increased due to an increase in commissions, resulting from higher commission scales, an increase in premium, and settlements with wholesale distributors related to discontinued group health business. These increases were offset by a decrease in general expenses related to both our group medical and group Medicare supplement insurance products. Individual life and disability insurance operating expenses also increased \$15.6 million, primarily due to an increase in amortization of deferred policy acquisition costs related to individual disability insurance.

Income taxes increased \$66.9 million to \$79.2 million in 2000, from \$12.3 million in 1999. The effective income tax rate for this segment was 33% in 2000 and 12% in 1999. The effective tax rate for 2000 was lower than the corporate income tax rate of 35% due to tax-exempt income. The effective income tax rate for 1999 was lower than the corporate income tax rate of 35%, primarily resulting from overestimated deferred taxes related to health insurance reserves in 1998, the effects of which were reversed in 1999 and also due to tax-exempt income.

As a result of the foregoing factors, operating earnings increased \$71.6 million, or 79%, to \$162.3 million in 2000, from \$90.7 million in 1999.

Net realized capital gains, as adjusted, increased \$37.2 million to \$47.3 million in 2000, from \$10.1 million in 1999. The increase was primarily due to net realized capital gains, as adjusted, related to the sale of our investment in United Payors and United Providers. We sold a portion of our investment in 1999, realizing an after-tax capital gain of \$17.9 million. In 2000, we sold our remaining investment and realized an after-tax capital gain of \$58.9 million. The increase in capital gains was partially offset by a \$2.3 million increase in net realized capital losses on sales of fixed income securities, as a result of our investment portfolio repositioning strategy to sell lower yielding fixed income securities to allow for reinvestment in higher yielding fixed income securities.

As a result of the foregoing factors, net income increased \$108.8 million, or 108%, to \$209.6 million in 2000, from \$100.8 million in 1999.

#### YEAR ENDED DECEMBER 31, 1999 COMPARED TO YEAR ENDED DECEMBER 31, 1998

Premiums and other considerations increased \$64.0 million, or 2%, to \$3,190.6 million in 1999, from \$3,126.6 million in 1998. In 1999, group health insurance premiums increased \$55.3 million, as a result of increased sales of our dental insurance products. Premiums and other considerations also increased \$43.4 million for Medicare supplement insurance products and \$40.5 million for group medical insurance products, a result of prices being more competitive and new sales incentives. Premiums increased \$9.1 million due to an increase in sales of individual disability insurance products, as a result of increased marketing efforts. Premiums also increased \$3.4 million for group disability insurance products, due to growth in our short-term disability insurance product. The increases were partially offset by a \$77.2 million decrease in group life insurance products, due to our decision to terminate our participation during 1998 in two large government reinsurance pools that were producing inadequate returns. Also, individual traditional life insurance premiums decreased by \$11.5 million in 1999, continuing a shift in customer preference from traditional life insurance products to universal life and variable life insurance products.

Fees and other revenues increased \$33.5 million, or 23%, to \$180.2 million in 1999, from \$146.7 million in 1998. Fees and other revenues increased in 1999, primarily due to a \$15.1 million increase in fee revenues from our group fee-for-service business, a result of increased sales due to focused marketing and distribution efforts to provide more clients with customized services that resulted in higher fees. Also, fee revenues from individual interest-sensitive life insurance products increased \$12.0 million in 1999. The increase reflects the shift in customer preference from traditional life insurance products to universal life and variable life insurance products, as previously discussed. Fee revenues from traditional life insurance products increased \$2.2 million, due to growth in reinsurance fee revenues associated with term life insurance products. Fee revenues from dental insurance products and services increased \$2.0 million, related to our 1998 acquisition of Dental Net, Inc., an integrated managed dental services organization. Fee revenues related to group life insurance also increased \$0.8 million.

Net investment income decreased \$5.1 million, or 1%, to \$614.7 million in 1999, from \$619.8 million in 1998. The decrease in 1999 was primarily due to a decrease in average investment yields for the segment. The yield on the weighted average invested assets and cash was 7.5% in 1999, compared to 7.8% in 1998. The decrease reflects lower interest rates on new fixed income investments. The decrease was partially offset by a \$247.8 million, or 3%, increase in average invested assets for the segment.

Benefits, claims and settlement expenses increased \$109.6 million, or 4%, to \$2,714.9 million in 1999, from \$2,605.3 million in 1998. The increase in 1999 was primarily due to a \$122.3 million increase in group medical benefits and reserve increases, and a \$53.8 million increase in Medicare supplement benefits and reserve increases, primarily a result of claim reserves established in 1999, as a result of poor claim experience through the third quarter of 1999 and an expectation that claims would continue to increase through the second quarter of 2000. Group medical and Medicare supplement benefits, claims and settlement expenses also increased, due to growth in the blocks of business. Dental insurance claims also increased \$41.7 million, due primarily to growth in our dental insurance business. The increase was partially offset by an \$87.0 million decrease in group life insurance claims and reserves, due primarily to our decision to terminate our participation in two large government reinsurance pools during 1998.

Dividends to policyholders decreased \$4.4 million, or 1%, to \$295.6 million in 1999, from \$300.0 million in 1998. The decrease was primarily due to a \$13.9 million decrease in group life and health insurance dividends. After July 1, 1998, new issues and renewals of group life and health contracts were in the form of non-participating policies. The policies included experience refund provisions that were reported as reductions of premiums in 1999, instead of as dividends to policyholders. The change in presentation did not affect net income. The decrease was partially offset by a \$9.5 million





increase in individual traditional life insurance dividends, primarily a result of increases in the cash values of the policies and in the interest rates credited to the policies.

Operating expenses decreased \$20.4 million, or 2%, to \$872.0 million in 1999, from \$892.4 million in 1998. Operating expenses were lower in 1999, primarily due to a \$28.3 million decrease in individual life and disability insurance expenses due to a decrease in amortization of deferred policy acquisition costs in 1999 compared to 1998. Amortization was higher in 1998, due to loss recognition on older blocks of business. The decrease was partially offset by a \$7.9 million increase in group life and health insurance expenses, primarily due to an increase in the distribution costs related to the acquisition of a distribution system, higher commission scales and an increase in dental insurance operating expenses due to our acquisition of Dental Net, Inc.

Income taxes decreased \$33.1 million, or 73%, to \$12.3 million in 1999, from \$45.4 million in 1998. The effective income tax rate for this segment was 12% in 1999 and 48% in 1998, compared to the corporate income tax rate of 35%. The effective tax rates differed from the corporate income tax rate in 1999 and 1998, due to overestimated deferred taxes related to health reserves in 1998, the effects of which were reversed in 1999.

As a result of the foregoing factors, operating earnings increased \$40.7 million, or 81%, to \$90.7 million in 1999, from \$50.0 million in 1998.

Net realized capital gains, as adjusted, increased \$8.2 million to \$10.1 million in 1999, from \$1.9 million in 1998, primarily due to a \$17.9 million net realized capital gain related to the sale of a portion of our equity investment in United Payors and United Providers. This capital gain was offset by a net \$9.7 million decrease in net realized capital gains, primarily due to net realized capital losses on sales of fixed income investments, as a result of our investment portfolio repositioning strategy to sell lower yielding fixed income securities to allow for reinvestment in higher yielding fixed income securities.

As a result of the foregoing factors and the inclusion of non-recurring items in 1998, net income decreased \$11.2 million, or 10%, to \$100.8 million in 1999, from \$112.0 million in 1998. Net income was higher in 1998, primarily due to the positive impacts of non-recurring items totaling \$60.1 million, net of tax, which included a \$76.5 million release of tax reserves, as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items," and expenses related to amortization of deferred policy acquisition costs associated with the formation of the mutual insurance holding company.

MORTGAGE BANKING SEGMENT

The table below presents certain summary financial data relating to the Mortgage Banking segment for the periods indicated:

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
	-----				
	(\$ IN MILLIONS)				
OPERATING EARNINGS DATA:					
Operating Revenues:(1)					
Loan servicing.....	\$ 181.0	\$ 155.2	\$ 313.8	\$ 286.5	\$ 235.4
Loan production.....	112.1	25.5	46.0	111.8	105.2
	-----	-----	-----	-----	-----
Total operating revenues.....	293.1	180.7	359.8	398.3	340.6
Expenses:					
Loan servicing.....	129.5	97.6	215.3	241.3	180.9
Loan production.....	57.8	30.1	67.4	69.5	69.3
	-----	-----	-----	-----	-----
Total expenses.....	187.3	127.7	282.7	310.8	250.2
	-----	-----	-----	-----	-----
Pre-tax operating earnings.....	105.8	53.0	77.1	87.5	90.4
Income taxes.....	37.0	18.6	27.1	30.7	31.6
	-----	-----	-----	-----	-----
Operating earnings.....	68.8	34.4	50.0	56.8	58.8
	-----	-----	-----	-----	-----
Net realized capital gains (losses), as adjusted.....	--	--	--	--	--
Non-recurring items.....	--	--	--	--	--
	-----	-----	-----	-----	-----
GAAP REPORTED:					
Net income.....	\$ 68.8	\$ 34.4	\$ 50.0	\$ 56.8	\$ 58.8
	=====	=====	=====	=====	=====
OTHER DATA:					
Mortgage loan production volume.....	\$15,368.4	\$ 3,290.2	\$ 8,311.8	\$13,307.3	\$12,120.5
Gain on sale of mortgage loans.....	68.5	2.2	9.4	55.2	59.5
Mortgage loan servicing portfolio.....	64,439.5	51,381.2	55,987.4	51,875.5	41,973.0
Gain on sale of mortgage loan servicing rights.....	6.8	14.0	14.9	5.5	1.8

(1) Excludes net realized capital gains (losses) and their impact on recognition of front-end fee revenues.

SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

Total operating revenues increased \$112.4 million, or 62%, to \$293.1 million for the six months ended June 30, 2001, from \$180.7 million for the six months ended June 30, 2000. The increase was primarily due to an \$86.6 million increase in mortgage loan production revenues, reflecting the increase in mortgage loan production volume during the six months ended June 30, 2001. In addition, mortgage loan servicing revenues increased \$25.8 million, reflecting the growth in the mortgage loan servicing portfolio. The increase in mortgage loan servicing revenues was partially offset by a decrease in gain on sales of mortgage loan servicing rights, reflecting a decline in the volume of servicing rights sold during the six months ended June 30, 2001.

Total expenses increased \$59.6 million, or 47%, to \$187.3 million for the six months ended June 30, 2001, from \$127.7 million for the six months ended June 30, 2000. The increase was primarily due to a \$31.9 million increase in mortgage loan servicing expenses due to growth in the mortgage loan servicing portfolio. Also contributing to expense growth was a decrease in net gains on servicing hedge activity recognized in the six months ended June 30, 2001, compared to the six months ended June 30, 2000. Mortgage loan production expenses increased \$27.7 million, reflecting the increase in mortgage loan production volume.

Income taxes increased \$18.4 million, or 99%, to \$37.0 million for the six months ended June 30, 2001, from \$18.6 million for the six months ended June 30, 2000. The effective income tax rate for this segment was 35% for both the six months ended June 30, 2001 and 2000.

As a result of the foregoing factors, operating earnings and net income increased \$34.4 million, or 100%, to \$68.8 million for the six months ended June 30, 2001, from \$34.4 million for the six months ended June 30, 2000.

YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

Total operating revenues decreased \$38.5 million, or 10%, to \$359.8 million in 2000, from \$398.3 million in 1999. The decrease was primarily due to a \$65.8 million decrease in mortgage loan production revenues, reflecting the decrease in mortgage loan production volume during 2000. The decrease in total revenues was partially offset by a

\$27.3 million increase in mortgage loan servicing revenues, primarily due to growth in the average balance of the mortgage loan servicing portfolio. Additionally, an increase in mortgage loan servicing fee revenues was the result of the sale of mortgage loan servicing rights, representing approximately \$1.0 billion from the mortgage loan servicing portfolio, as part of our mortgage loan servicing strategy.

Total expenses decreased \$28.1 million, or 9%, to \$282.7 million in 2000 from \$310.8 million in 1999. The decrease was primarily due to a \$26.0 million decrease in expenses related to mortgage loan servicing, primarily a result of net gains we earned on hedges related to our servicing portfolio in 2000. In the second quarter of 2000, we shifted our servicing hedge portfolio from U.S. Treasury-related instruments to London Inter-Bank Offer Rate based hedges including swaps and swaptions, which resulted in net gains of \$10.2 million. The decrease was also due to a \$2.1 million decrease in mortgage loan production expenses related to the decrease in mortgage loan production volume during 2000.

Income taxes decreased \$3.6 million, or 12%, to \$27.1 million in 2000, from \$30.7 million in 1999. The effective income tax rate for this segment was 35% in both 2000 and 1999.

As a result of the foregoing factors, operating earnings and net income decreased \$6.8 million, or 12%, to \$50.0 million in 2000, from \$56.8 million in 1999.

YEAR ENDED DECEMBER 31, 1999 COMPARED TO YEAR ENDED DECEMBER 31, 1998

Total operating revenues increased \$57.7 million, or 17%, to \$398.3 million in 1999, from \$340.6 million in 1998. The increase was primarily due to a \$58.4 million increase in residential mortgage loan servicing revenues. The increase in revenues was partially offset by a \$7.3 million decrease in revenues, resulting from our sale of Principal Portfolio Services, Inc., a mortgage loan due diligence service provider, in January 1999. The mortgage loan servicing portfolio increased by \$9.9 billion, or 24%, to \$51.9 billion in 1999, from \$42.0 billion in 1998. The mortgage loan servicing portfolio growth during 1999 was due to higher mortgage loan production and acquisitions of mortgage loan servicing rights, representing \$5.6 billion in unpaid principal balances. Mortgage loan production related revenues increased \$6.6 million, due to higher mortgage loan production volumes in 1999.

Total expenses increased \$60.6 million, or 24%, to \$310.8 million in 1999, from \$250.2 million in 1998. The increase in total expenses was attributable to a \$67.6 million increase related to mortgage loan servicing, primarily reflecting an increase in amortization of mortgage loan servicing rights, a result of the increase in our mortgage loan servicing portfolio. This increase was partially offset by a \$7.2 million decrease in expenses, resulting from our sale of Principal Portfolio Services, Inc.

Income taxes decreased \$0.9 million, or 3%, to \$30.7 million in 1999, from \$31.6 million in 1998. The effective income tax rate for this segment was 35% for both 1999 and 1998.

As a result of the foregoing factors, operating earnings and net income decreased \$2.0 million, or 3%, to \$56.8 million in 1999, from \$58.8 million in 1998.

CORPORATE AND OTHER SEGMENT

The table below presents summary financial data relating to the Corporate and Other segment for the periods indicated:

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	2000	1999	1998
	-----				
	(\$ IN MILLIONS)				
OPERATING EARNINGS DATA:					
Operating Revenues:(1)					
Total operating revenues.....	\$ 57.5	\$ 40.5	\$ 97.1	\$ 61.9	\$342.5
Expenses:					
Total expenses.....	13.5	29.3	14.4	54.1	430.6
Pre-tax operating earnings (loss).....	44.0	11.2	82.7	7.8	(88.1)
Income taxes (benefits).....	11.9	7.2	15.0	(1.7)	(43.8)
Operating earnings (loss).....	32.1	4.0	67.7	9.5	(44.3)
Net realized capital gains (losses), as adjusted.....	(41.5)	4.6	80.3	284.5	292.1
Non-recurring items.....	(20.7)	(75.8)	(101.0)	--	7.5
-----					
GAAP REPORTED:					
Net income (loss).....	\$(30.1)	\$(67.2)	\$ 47.0	\$294.0	\$255.3
	=====	=====	=====	=====	=====

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(1) Excludes net realized capital gains (losses) and their impact on recognition of front-end fee revenues.

SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

Total operating revenues increased \$17.0 million, or 42%, to \$57.5 million for the six months ended June 30, 2001, from \$40.5 million for the six months ended June 30, 2000. Operating revenues increased \$22.9 million, primarily as a result of improved investment yields for the segment. The increase was partially offset by a \$5.7 million decrease related to inter-segment eliminations included in this segment, which was offset by a corresponding change in total expenses.

Total expenses decreased \$15.8 million, or 54%, to \$13.5 million for the six months ended June 30, 2001, from \$29.3 million for the six months ended June 30, 2000. A \$5.7 million decrease was related to inter-segment eliminations included in this segment. Interest expense on commercial paper and private debt securities issued in connection with the acquisition of BT Financial Group decreased \$4.6 million, primarily as a result of the repayment of commercial paper. In addition, interest expense decreased \$4.2 million as a result of a reduction of commercial real estate debt on home office properties. Interest expense also decreased \$3.8 million, primarily due to an accrual of interest to be received as a result of the resolution of a favorable IRS tax audit event in 2000. The decreases were partially offset by a \$2.3 million increase related to interest expense on short-term borrowings.

Income taxes increased \$4.7 million, or 65%, to \$11.9 million for the six months ended June 30, 2001, from \$7.2 million for the six months ended June 30, 2000. The effective income tax rates for this segment were 27% for the six months ended June 30, 2001, and 64% for the six months ended June 30, 2000. The effective income tax rate for the six months ended June 30, 2001, was lower than the corporate income tax rate of 35% because of tax exempt income, non-taxable income and tax credits. The effective income tax rate for the six months ended June 30, 2000, was higher than the corporate income tax rate of 35% due to an increase in income tax reserves established for contested IRS tax audit matters.

As a result of the foregoing factors, operating earnings increased \$28.1 million to \$32.1 million for the six months ended June 30, 2001, from \$4.0 million for the six months ended June 30, 2000.

Net realized capital gains (losses), as adjusted, decreased \$46.1 million to \$41.5 million of net realized capital losses for the six months ended June 30, 2001, from \$4.6 million of net realized capital gains for the six months ended June 30, 2000. The decrease was primarily due to net realized capital losses for the six months ended June 30, 2001 on sales of equity securities, a result of the decline in the equity markets.

As a result of the foregoing factors and the inclusion of non-recurring items, net loss decreased \$37.1 million, or 55%, to \$30.1 million for the six months ended June 30, 2001, from \$67.2 million for the six months ended June 30, 2000. For the six months ended June 30, 2001, net income included the negative effect of non-recurring items totaling \$20.7 million, net of tax, related to: (1) expenses related to our demutualization (\$14.8 million) and (2) a loss contingency reserve established for sales practices litigation (\$5.9 million). For the six months ended June 30, 2000, net income included the negative effect of non-recurring items totaling \$75.8 million, net of tax, related to: (1) a loss contingency reserve established for sales practices litigation (\$75.0 million) and (2) expenses related to our demutualization (\$0.8 million). The non-recurring items were previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items".

YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

Total operating revenues increased \$35.2 million, or 57%, to \$97.1 million in 2000, from \$61.9 million in 1999. Net investment income increased \$71.0 million, as a result of improved investment yields for the segment. The increase was partially offset by an \$11.5 million decrease in net investment income, reflecting a reduction in average invested assets, primarily due to the sale of invested assets in 1999 to partially fund the acquisition of BT Financial Group. The increase in total revenues was also partially offset by a \$9.0 million decrease related to a change in inter-segment eliminations included in this segment, which was offset by a corresponding change in total expenses. In addition, the increase was also partially offset by an \$8.5 million decrease in fees and other revenues, primarily related to the termination of a reinsurance and participation agreement under which we continued to receive fee revenues in 1999, but not in 2000. Net investment income also decreased \$5.0 million related to our pro rata share of net loss of HealthExtras, Inc., a company in which we hold a minority interest.

Total expenses decreased \$39.7 million, or 73%, to \$14.4 million in 2000, from \$54.1 million in 1999. Interest expense related to IRS tax audit matters decreased \$40.8 million, primarily due to a net recovery of previously paid interest related to a successful tax audit appeal. Expenses also decreased \$33.2 million due to the cessation of interim service agreements with Coventry at the end of 1999. A \$9.0 million decrease in operating expenses was related to a change in inter-segment eliminations included in this segment. The decreases were partially offset by \$31.2 million of additional interest expense in 2000 on private debt securities and commercial paper issued in connection with the acquisition of BT Financial Group in August 1999. In addition, a \$10.0 million increase was related primarily to corporate initiatives funded by this segment.

Income tax expense (benefits) increased \$16.7 million to \$15.0 million of tax expense in 2000, from a \$1.7 million income tax benefit in 1999. The increase was primarily a result of an increase in pre-tax operating earnings, which included tax exempt income. The effective income tax rate for this segment was lower than the corporate income tax rate of 35% in both 2000 and 1999 because of tax exempt income.

As a result of the foregoing factors, operating earnings increased \$58.2 million to \$67.7 million in 2000, from \$9.5 million in 1999.

Net realized capital gains, as adjusted, decreased \$204.2 million, or 72%, to \$80.3 million in 2000, from \$284.5 million in 1999. The decrease was primarily due to decreased sales of invested assets, primarily equity securities, in 2000. We sold a significant portion of our equity securities portfolio in 1999 and 1998 to reduce our exposure to common stock and to realize appreciation.

As a result of the foregoing factors and the inclusion of non-recurring items in 2000, net income decreased \$247.0 million, or 84%, to \$47.0 million in 2000, from \$294.0 million in 1999. In 2000, net income included the negative effect of non-recurring items totaling \$101.0 million, net of tax, related to: (1) a loss contingency reserve established for sales practices litigation (\$93.8 million) and (2) demutualization costs (\$7.2 million), as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items".

#### YEAR ENDED DECEMBER 31, 1999 COMPARED TO YEAR ENDED DECEMBER 31, 1998

Total operating revenues decreased \$280.6 million, or 82%, to \$61.9 million in 1999, from \$342.5 million in 1998. Our HMO operations contributed \$272.6 million of total revenues in 1998, prior to being transferred to Coventry.

Excluding the impact of HMO operations, total operating revenues decreased \$8.0 million, or 11%, to \$61.9 million in 1999, from \$69.9 million in 1998. Our U.S. asset management operations were transferred to the U.S. Asset Management and Accumulation segment, effective January 1, 1999, and the financial results of the U.S. asset management operations are no longer reported in the Corporate and Other segment. This transfer resulted in decreased revenues of \$22.7 million, representing \$10.6 million of fee revenues collected from institutional clients for investment management services in 1998 and \$12.1 million of net investment income related to the operations in 1998. An additional decrease in net investment income of \$10.5 million was primarily due to \$520.0 million of invested assets sold in 1999 to partially fund the acquisition of BT Financial Group. The decreases were partially offset by a \$28.9 million increase in net investment income, related to our pro rata share of Coventry's net income, as a result of Coventry's improved earnings in 1999, as compared to 1998.

Total expenses decreased \$376.5 million, or 87%, to \$54.1 million in 1999, from \$430.6 million in 1998. Our HMO operations contributed \$342.3 million of expenses in 1998 prior to being transferred to Coventry.

Excluding the impact of HMO operations, total expenses decreased \$34.2 million, or 39%, to \$54.1 million in 1999, from \$88.3 million in 1998. The decrease was primarily related to \$16.3 million of operating expenses of the U.S. asset management operations that were transferred to the U.S. Asset Management and Accumulation segment, effective January 1, 1999. Prior to the transfer, these expenses were reported in the Corporate and Other segment.

Income tax benefits decreased \$42.1 million, or 96%, to \$1.7 million in 1999, from \$43.8 million in 1998. As a result of an increase in pre-tax operating earnings, income tax benefits decreased \$33.5 million. The remaining \$8.6 million income tax benefit decrease was related to settlements of prior year IRS tax audits.

As a result of the foregoing factors, operating earnings increased \$53.8 million, or 121%, to \$9.5 million in 1999, from a \$44.3 million operating loss in 1998.

Net realized capital gains, as adjusted, decreased \$7.6 million, or 3%, to \$284.5 million in 1999, from \$292.1 million in 1998. We sold a significant portion of our equity securities portfolio in 1999 and 1998 to reduce our exposure to common stock and to realize appreciation. Our sales of invested assets, primarily equity securities, increased in 1999 and resulted in a \$33.1 million increase in realized capital gains. This increase was more than offset by a \$40.7 million increase in capital gains taxes in 1999, compared to 1998. Capital gains taxes were lower in 1998, due to permanent income tax differences in that year related to a gain on appreciated common stock contributed to the Principal Financial Group Foundation that was not realized for income tax purposes.

As a result of the foregoing factors and the inclusion of non-recurring items in 1998, net income increased \$38.7 million, or 15%, to \$294.0 million in 1999, from \$255.3 million in 1998. In 1998, net income included non-recurring items totaling \$7.5 million, net of tax, related to:

- the positive effects of a release of tax reserves; and
- the negative effects of (a) a contribution related to permanent endowment of the Principal Financial Group Foundation and (b) expenses related to our reorganization into a mutual insurance holding company structure, as previously discussed under the caption "-- Transactions Affecting Comparability of Results of Operations -- Operating Earnings and Non-Recurring Items".

## LIQUIDITY AND CAPITAL RESOURCES

Liquidity describes the ability of a company to generate sufficient cash flows to meet the cash requirements of business operations. The primary source of our liquidity will be dividends we receive from Principal Life. We could also receive dividends from our other direct subsidiaries, including Princor Financial Services Corporation, Principal Financial Services (Australia) Inc., Principal Internacional de Chile, S.A. and PFG do Brasil Ltda. However, given the historical cash flows of the operations and financial results of these subsidiaries, it is unlikely that we may rely upon them for significant cash flow in the next twelve months. In addition, under the plan of conversion, we may retain up to \$250.0 million of the net proceeds from this offering to be used for working capital, payment of dividends and other general corporate purposes.

The payment of dividends by Principal Life to us is limited by Iowa laws. Under Iowa laws, Principal Life may pay dividends only from the earned profits arising from its business and must receive the prior approval of the Insurance Commissioner of the State of Iowa to pay any dividend that would exceed statutory limitations. The current statutory limitation is the greater of:

- 10% of Principal Life's statutory surplus as of the previous calendar year-end; or
- the net gain from operations of Principal Life determined on a statutory basis for the previous calendar year.

Iowa law gives the Insurance Commissioner of the State of Iowa discretion to disapprove requests for dividends in excess of these limits. Principal Life was able to pay approximately \$760.9 million in statutory dividends in 2001 based on its 2000 statutory financial results without being subject to the restrictions on payment of extraordinary stockholder dividends, all of which as of August 24, 2001 has been declared and paid. The ability to make dividends or distributions in the future will depend on the amounts of statutory surplus and net gain from operations determined on a statutory basis for the previous year.

Our primary uses of liquidity could include payment of dividends on our common stock, interest payments and any other payments related to debt servicing, payment of general operating expenses, contributions to subsidiaries, potential acquisitions and the repurchase of our common stock. Any such repurchases would occur after due consideration and approval by our board of directors.

## SOURCES AND USES OF CASH OF CONSOLIDATED OPERATIONS

Net cash provided by operating activities was \$1,452.2 million and \$815.3 million for the six months ended June 30, 2001 and 2000, respectively. The increase was primarily due to a decrease in cash paid for operating expenses. Net cash provided by operating activities was \$2,637.3 million, \$2,106.0 million and \$1,963.1 million for the years ended December 31, 2000, 1999 and 1998, respectively. The increase in 2000 was primarily due to an increase in customer and escrow deposit liabilities for Principal Bank compared to 1999. The increase in 1999 resulted primarily from an increase related to current and deferred income taxes compared to 1998.

Net cash used in investing activities was \$2,959.6 million for the six months ended June 30, 2001 and net cash provided by investing activities was \$310.0 million for the six months ended June 30, 2000. The increase in cash used was primarily due to an increase in net cash invested in available-for-sale securities during the period. Net cash used in investing activities was \$1,273.3 million, \$3,341.2 million and \$739.6 million for the years ended December 31, 2000, 1999 and 1998, respectively. The decrease in cash used in 2000 was primarily due to a decrease in purchases of interests in subsidiaries in 2000 compared to 1999, primarily a result of the purchase of BT Financial Group in 1999. The increase in 1999 compared to 1998 resulted primarily from an increase in purchases of available-for-sale fixed maturities and purchases of interests in subsidiaries, primarily BT Financial Group.

Net cash provided by financing activities was \$952.7 million for the six months ended June 30, 2001 and net cash used in financing activities was \$1,109.1 million for the six months ended June 30, 2000. Net cash provided increased as a result of a positive inflow of net investment contract deposits and net proceeds received from short-term borrowings. Net cash used in financing activities was \$1,006.9 million, net cash provided by financing activities was \$1,343.9 million and net cash used in financing activities was \$1,308.7 million for the years ended December 31, 2000, 1999 and 1998, respectively. The increase in cash used in 2000 compared to 1999 was primarily due to the change in net deposits related to investment contracts and due to a decrease in issuance of debt. The increase in cash provided in 1999 resulted primarily from issuance of debt, primarily in connection with the acquisition of BT Financial Group in August 1999, and an increase in net deposits related to investment contract deposits compared to 1998.

Cash flow requirements are also supported by committed lines of credit totaling \$600.0 million, of which there were no outstanding balances as of June 30, 2001. The lines of credit are available to provide backup of the commercial paper programs.

Given the historical cash flow of our subsidiaries and the financial results of these subsidiaries, we believe the cash flow from our consolidated operating activities over the next year will provide sufficient liquidity for our operations, as well as to satisfy interest payments and any payments related to debt servicing.





PRINCIPAL LIFE

Historically, the principal cash flow sources for Principal Life have been premiums from life and health insurance products, pension and annuity deposits, asset management fee revenues, administrative services fee revenues, income from investments, proceeds from the sales or maturity of investments and short-term borrowings. Cash outflows consist primarily of payment of benefits to policyholders and beneficiaries, income and other taxes, current operating expenses, payment of dividends to policyholders, payments in connection with investments acquired, payments made to acquire subsidiaries, payment of dividends to parent, and payments relating to policy and contract surrenders, withdrawals, policy loans, interest expense and repayment of short-term borrowings.

Principal Life maintains investment strategies generally intended to provide adequate funds to pay benefits without forced sales of investments. Products having liabilities with longer lives, such as life insurance and full-service payout pension products, are matched with assets having similar estimated lives such as mortgage loans, long-term bonds and private placement bonds. Shorter-term liabilities are matched with investments such as short and medium-term fixed maturities. In addition, highly liquid, high quality short-term U.S. Treasury securities and other liquid investment grade fixed maturities are held to fund anticipated operating expenses, surrenders, withdrawals and development and maintenance expenses associated with new products and technologies. See "-- Quantitative and Qualitative Information about Market Risk -- Interest Rate Risk" for a discussion of duration matching.

Our privately placed fixed maturity securities, commercial mortgage loans and real estate investments are generally less liquid than our publicly traded fixed maturity securities. As of June 30, 2001 these asset classes represented approximately 52% of the value of our consolidated invested assets.

Life insurance companies generally produce a positive cash flow from operations, as measured by the amount by which cash inflows are adequate to meet benefit obligations to policyholders and normal operating expenses as they are incurred. The remaining cash flow is generally used to increase the asset base to provide funds to meet the need for future policy benefit payments and for writing and acquiring new business. It is important to match the investment portfolio maturities to the cash flow demands of the type of annuity, investment or insurance product being provided. Principal Life continuously monitors benefits, surrenders and maturities to provide projections of future cash requirements. As part of this monitoring process, Principal Life performs cash flow testing of many of its assets and liabilities under various scenarios to evaluate the adequacy of reserves. In developing its investment strategy, Principal Life establishes a level of cash and securities which, combined with expected net cash inflows from operations, maturities of fixed maturity investments and principal payments on mortgage-backed securities, are believed adequate to meet anticipated short-term and long-term benefit and expense payment obligations. There can be no assurance that future experience regarding benefits and surrenders will be similar to historic experience since withdrawal and surrender levels are influenced by such factors as the interest rate environment and the claims paying ability and financial strength ratings of Principal Life.

Principal Life takes into account asset-liability management considerations in the product development and design process. Contract terms of 97% of Principal Life's interest-sensitive products as of December 31, 2000 include surrender and withdrawal provisions which mitigate the risk of losses due to early withdrawals. These provisions generally do one or more of the following: limit the amount of penalty-free withdrawals, limit the circumstances under which withdrawals are permitted, or assess a surrender charge or market value adjustment relating to the underlying assets. The market value adjustment feature in Principal Life's fixed annuity products adjusts the surrender value of a contract in the event of surrender prior to the end of the contract period to protect Principal Life against losses due to higher interest rates at the time of surrender. The following table summarizes Principal Life's statutory liabilities for annuities and deposit funds by their contractual withdrawal provisions:

	AS OF DECEMBER 31, 2000
	----- (\$ IN MILLIONS)
STATUTORY LIABILITIES FOR ANNUITIES AND DEPOSIT FUNDS:	
Not subject to discretionary withdrawal.....	\$17,813.8
Subject to discretionary withdrawal with adjustments:	
Specified surrender charges at book value less surrender charge of 5% or more.....	670.9
Market value adjustments.....	40,535.0
	-----
Subtotal.....	59,019.7
Subject to discretionary withdrawal without adjustments...	2,138.1
	-----
Total.....	\$61,157.8
	=====

INTERNATIONAL OPERATIONS

BT Financial Group required no infusions of capital for the six months ended June 30, 2001 and \$59.3 million and \$1.6 million for the years ended December

31, 2000 and 1999, respectively, to meet cash flow requirements. We do not

anticipate making future capital contributions. Primary sources of cash inflows for BT Financial Group are fee revenues and interest spread earned on margin lending operations. Cash outflows consist primarily of operating expenses.

Principal International is in a development or entry stage in several countries. Historically, principal cash flow sources for Principal International have been pension and annuity deposits, asset management fee revenues, administrative services fee revenues, insurance premiums, income from investments, proceeds from the sales or maturity of investments and short-term borrowings. Cash outflows consist primarily of payment of benefits to policyholders and beneficiaries, income and other taxes, current operating expenses, payments in connection with investments acquired, and payments relating to policy and contract surrenders, withdrawals, policy loans, interest expense and repayment of short-term borrowings.

Principal International maintains investment strategies generally intended to provide adequate funds to pay benefits without forced sales of investments. Highly liquid, high quality short-term government securities and other liquid investment grade fixed maturities are held to fund anticipated operating cash outflows and development and maintenance expenses associated with new products and technologies.

Principal International's operating companies monitor benefits, surrenders and maturities to provide projections of future cash requirements. There can be no assurance that future experience regarding benefits and surrenders will be similar to historic experience since withdrawal and surrender levels are influenced by factors such as the interest rate environment.

Our Brazilian and Chilean operations produced a positive cash flow from operations in the first six months of 2001 and in 2000. These cash flows have been historically maintained at the local country level for strategic expansion purposes. Our other international operations have required infusions of capital of \$19.7 million for the six months ended June 30, 2001 and \$75.8 million, \$126.8 million and \$219.7 million for the years ended December 31, 2000, 1999 and 1998, respectively, to meet the cash flow requirements of those operations or to fund acquisitions. These other operations are primarily in the start-up stage or are expanding in the short term. Our capital funding of these operations is consistent with our long term strategy to establish viable companies that can sustain future growth from internally generated sources.

#### QUANTITATIVE AND QUALITATIVE INFORMATION ABOUT MARKET RISK

##### MARKET RISK EXPOSURES AND RISK MANAGEMENT

Market risk is the risk that we will incur losses due to adverse fluctuations in market rates and prices. Our primary market risk exposure is to changes in interest rates, although we also have exposures to changes in equity prices and foreign currency exchange rates.

The active management of market risk is an integral part of our operations. We manage our overall market risk exposure within established risk tolerance ranges by using the following approaches:

- rebalance our existing asset or liability portfolios;
- control the risk structure of newly acquired assets and liabilities; or
- use derivative instruments to modify the market risk characteristics of existing assets or liabilities or assets expected to be purchased.

##### INTEREST RATE RISK

Interest rate risk is the risk that we will incur economic losses due to adverse changes in interest rates. Our exposure to interest rate risk stems largely from our substantial holdings of guaranteed fixed rate liabilities in our U.S. Asset Management and Accumulation segment.

We seek to earn returns on investments that enhance our ability to offer competitive rates and prices to customers while contributing to attractive and stable profits and long-term capital growth. Accordingly, our investment decisions and objectives are a function of the underlying risks and product profiles of each primary business operation. In addition, we diversify our product portfolio offerings to include products that contain features that will protect us against fluctuations in interest rates. Those features include adjustable crediting rates, policy surrender charges and market value adjustments on liquidations.

We manage the interest rate risk inherent in our assets relative to the interest rate risk inherent in our liabilities. One of the measures we use to quantify this exposure is duration. Duration measures the change in the fair value of assets and liabilities for given changes in interest rates. For example, if interest rates increase by a hypothetical 100 basis points, the fair value of an asset with a duration of 5 years is expected to decrease in value by approximately 5%.

To calculate duration, we project asset and liability cashflows. These cashflows are discounted to a net present value basis using a spot yield curve, which is a blend of the spot yield curves for each of the asset types in the

portfolio. Duration is calculated by re-calculating these cashflows and redetermining the net present value based upon an alternative level of interest rates, and determining the percentage change in fair value.

As of June 30, 2001, the difference between the asset and liability durations on our primary duration managed portfolio was 0.04 years. This duration gap indicates that as of this date the sensitivity of the fair value of our assets to interest rate movements is greater than that of the fair value of our liabilities. Our goal is to minimize the duration gap. Currently, our guidelines dictate that total duration gaps between the asset and liability portfolios must be within 0.25 years. The value of the assets in this portfolio was \$24,257.1 million as of June 30, 2001.

We also manage interest rate risk by employing a partial duration analysis. With this technique, the yield curve is dissected into various term components and a partial duration is calculated for each. Each partial duration represents the potential change in fair value of the asset or liability to interest rate shift in rates in the applicable component of the yield curve. We minimize potential volatility in the fair value of surplus of Principal Life as a result of changes in the yield curve by managing each partial duration gap between the assets and liabilities within established guidelines.

With respect to our primary duration managed portfolio, we use several methods to correct any potential total or partial duration gaps that are outside of our established risk tolerance ranges. We can rebalance the existing asset or liability portfolios or we can redirect new asset purchases until the asset portfolio is better aligned with the liabilities and our duration gaps are back within their limits. If a more expedient correction is desired, another method we use is forward interest rate swaps. These swaps are designed to move duration exposure from one specific point on the yield curve to another, and are an efficient way to quickly shift the partial and total duration profile of the asset portfolio so that duration gaps and hence interest rate risk is minimized.

For products such as whole life insurance, term life insurance and single premium deferred annuities, the liability cashflow is less predictable, and a duration-matching strategy is less reliable and manageable. We do, however, try to manage the duration of these portfolios. For these products, we manage interest rate risk based on a modeling process that considers the target average life, maturities, crediting rates and assumptions of policyholder behavior. As of June 30, 2001, the weighted-average difference between the asset and liability durations on these portfolios was 1.2 years. This duration gap indicates that as of this date the sensitivity of the fair value of our assets to interest rate movements is greater than that of the fair value of our liabilities. We attempt to monitor this duration gap consistent with our overall risk/reward tolerances. The value of the assets in these portfolios was \$12,184.7 million as of June 30, 2001.

We also have a block of participating general account pension business that passes the actual investment performance of the assets to the customer. The investment strategy of this block is to maximize investment return to the customer on a "best efforts" basis, and there is little or no attempt to manage the duration of this portfolio since there is little or no interest rate risk. The value of the assets in these portfolios was \$2,464.6 million as of June 30, 2001.

Using the assumptions and data in effect as of June 30, 2001, we estimate that a 100 basis point immediate, parallel increase in interest rates decreases the net fair value of our portfolio by \$169.3 million. The following table details the estimated changes by risk management strategy:

RISK MANAGEMENT STRATEGY	AS OF JUNE 30, 2001 VALUE OF TOTAL ASSETS	NET FAIR VALUE CHANGE
----- (\$ IN MILLIONS) -----		
Primary duration-managed.....	\$24,257.1	\$ (21.1)
Duration-monitored.....	12,184.7	(148.2)
Non duration-managed.....	2,464.6	--
	-----	-----
Total.....	\$38,906.4	\$(169.3)
	=====	=====

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

We are also exposed to interest rate risk in our Mortgage Banking segment. We manage this risk by striving to balance our loan origination and loan servicing operations, the two of which are generally counter-cyclical. In addition, we use various financial instruments, including derivatives contracts, to manage the interest rate risk specifically related to committed loans in the pipeline and mortgage servicing rights. The overall objective of our interest rate risk management policies is to offset changes in the values of these items

resulting from changes in interest rates. We do not speculate on the direction of interest rates in our management of interest rate risk.

We manage interest rate risk on our mortgage loan pipeline by buying and selling mortgage-backed securities in the forward markets, over-the-counter options on mortgage-backed securities, U.S. Treasury futures contracts and options on futures contracts. We also use interest rate floors, futures contracts, options on futures contracts, swaps and swaptions in hedging a portion of our portfolio of mortgage servicing rights from prepayment risk associated with changes in interest rates.

We measure pipeline interest rate risk exposure by adjusting the at-risk pipeline in light of the theoretical optionality of each applicant's rate/price commitment. The at-risk pipeline, which consists of closed loans and rate locks, is then refined at the product type level to express each product's sensitivity to changes in market interest rates in terms of a single current coupon MBS duration. Suitable hedges are selected and a similar methodology applied to this hedge position. We limit our risk exposure by requiring that the net position value not change by more than \$10 million given an instantaneous change in the benchmark MBS price of +/-2.5%. This price sensitivity analysis is performed at least once daily. The value of the loans in the pipeline as of June 30, 2001 was \$7.3 billion. Due to the impact of our hedging activities, we estimate that a 100 basis point immediate parallel increase in the interest rates decreases the June 30, 2001 net position value by less than \$24.4 million.

The financial risk associated with our mortgage servicing operations is the risk that the market value of the servicing asset falls below its GAAP book value. To measure this risk, we analyze each servicing risk tranche's GAAP book value in relation to the then current market value for similar servicing rights. We perform this valuation using option-adjusted spread valuation techniques applied to each risk tranche. We produce tranche market values at least monthly.

The market value of the servicing asset declines as interest rates decrease due to possible mortgage loan servicing rights impairment that may result from increased current and projected future prepayment activity. The change in value of the servicing asset due to interest rate movements is reduced by the use of financial instruments, including derivative contracts, that increase in aggregate value when interest rates decline. We recently shifted our servicing hedge portfolio from U.S. Treasury related instruments to London Inter-Bank Offer Rate hedges, including swaps and swaptions. Based on values as of June 30, 2001, a 100 basis point parallel decrease in interest rates produces a \$93 million decline in value of the servicing asset of our Mortgage Banking segment, due to the impact of these hedging vehicles and the current differences between current market values and GAAP book values.

**CASH FLOW VOLATILITY.** Cash flow volatility arises as a result of several factors. One is the inherent difficulty in perfectly matching the cash flows of new asset purchases with that of new liabilities. Another factor is the inherent cash flow volatility of some classes of assets and liabilities. In order to minimize cash flow volatility, we manage differences between expected asset and liability cash flows within pre-established guidelines.

We also seek to minimize cash flow volatility by restricting the portion of securities with redemption features held in our invested asset portfolio. These asset securities include redeemable corporate securities, mortgage-backed securities or other assets with options that, if exercised, could alter the expected future cash inflows. In addition, we limit sales liabilities with features such as puts or other options that may change the cash flow profile of the liability portfolio.

**DERIVATIVES.** We use various derivative financial instruments to manage our exposure to fluctuations in interest rates, including interest rate swaps, Principal Only swaps, interest rate floors, swaptions, U.S. Treasury futures, Treasury rate guarantees and mortgage-backed forwards and options. We use interest rate futures contracts and mortgage-backed forwards to hedge changes in interest rates subsequent to the issuance of an insurance liability, such as a guaranteed investment contract, but prior to the purchase of a supporting asset, or during periods of holding assets in anticipation of near term liability sales. We use interest rate swaps and Principal Only swaps primarily to more closely match the interest rate characteristics of assets and liabilities. They can be used to change the interest rate characteristics of specific assets and liabilities as well as an entire portfolio. Occasionally, we will sell a callable liability or a liability with attributes similar to a call option. In these cases, we will use interest rate swaptions or similar products to hedge the risk of early liability payment thereby transforming the callable liability into a fixed term liability.

We also seek to reduce call or prepayment risk arising from changes in interest rates in individual investments. We limit our exposure to investments that are prepayable without penalty prior to maturity at the option of the issuer, and we require additional yield on these investments to compensate for the risk that the issuer will exercise such option. An example of an investment we limit because of the option risk is residential mortgage-backed securities. We assess option risk in all investments we make and, when we assume such risk, we seek to price for it accordingly to achieve an appropriate return on our investments.

In conjunction with the interest rate swaps, interest rate swaptions and other derivatives, we are exposed to counterparty risk, or the risk that counterparty fails to perform the terms of the derivative contract. We actively manage this risk by:

- establishing exposure limits which take into account non-derivative exposure we have with the counterparty as well as derivative exposure;

- performing similar credit analysis prior to approval on each derivatives counterparty that we do when lending money on a long-term basis;
- limiting exposure to AA- credit or better;
- conducting stress-test analysis to determine the maximum exposure created during the life of a prospective transaction; and
- daily monitoring of counterparty credit ratings.

All new derivative counterparties are approved by the investment committee. We believe the risk of incurring losses due to nonperformance by our counterparties is remote and that such losses, if any, would not be material. Futures contracts trade on organized exchanges and, therefore, effectively have no credit risk.

The table below shows the interest rate sensitivity of our derivatives measured in terms of fair value. These exposures will change as a result of ongoing portfolio and risk management activities.

AS OF JUNE 30, 2001					
	NOTIONAL AMOUNT	WEIGHTED AVERAGE TERM (YEARS)	FAIR VALUE (NO ACCRUED INTEREST)		
			-100 BASIS POINT CHANGE	NO CHANGE	+100 BASIS POINT CHANGE
(\$ IN MILLIONS)					
Interest rate swaps.....	\$ 3,908.2	6.06(1)	\$ (35.8)	\$ 7.5	\$ 35.6
Principal Only swaps.....	250.0	2.56(1)	23.2	(11.3)	(18.9)
Interest rate floors.....	3,200.0	5.01(2)	62.2	44.1	(23.2)
U.S. Treasury futures.....	235.7	0.25(3)	(8.7)	2.3	9.4
Swaptions.....	1,815.0	2.87(4)	22.1	24.0	(18.3)
Treasury rate guarantees.....	61.0	0.04(5)	(3.3)	1.1	5.5
Mortgage-backed forwards and options.....	9,770.5	0.17(5)	(198.8)	552.5	243.4
Total.....	\$19,240.4		\$(139.1)	\$620.2	\$233.5

- (1) Based on maturity date of swap.
- (2) Based on maturity date of floor.
- (3) Based on maturity date.
- (4) Based on option date of swaption.
- (5) Based on settlement date.

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

DEBT ISSUED AND OUTSTANDING. As of June 30, 2001, the aggregate fair value of debt was \$1,390.4 million. A 100 basis point, immediate, parallel decrease in interest rates would increase the fair value of debt by approximately \$70.9 million.

AS OF JUNE 30, 2001			
	FAIR VALUE (NO ACCRUED INTEREST)		
	-100 BASIS POINT CHANGE	NO CHANGE	+100 BASIS POINT CHANGE
(\$ IN MILLIONS)			
7.95% notes payable, due 2004.....	\$ 217.5	\$ 211.6	\$ 205.9
8.2% notes payable, due 2009.....	526.8	495.9	467.2
7.875% surplus notes payable, due 2024.....	196.3	180.4	165.2
8% surplus notes payable, due 2044.....	97.9	88.3	80.0
Non-recourse mortgages and notes payable.....	154.0	145.4	137.5
Other mortgages and notes payable.....	268.8	268.8	268.8
Total long-term debt.....	\$1,461.3	\$1,390.4	\$1,324.6

#### EQUITY RISK

Equity risk is the risk that we will incur economic losses due to adverse fluctuations in a particular common stock. As of June 30, 2001, the fair value of our equity securities was \$578.8 million. A 10% decline in the value of the equity securities would result in an unrealized loss of \$57.9 million.

We also have indirect equity risk exposure with respect to BT Financial Group margin lending operations. Under the terms of this financing arrangement, BT Financial Group margin lending operations allow retail clients and independent financial advisors on behalf of clients, within limits approved by senior management, to borrow funds from BT Financial Group to invest in an approved list of securities and mutual fund investments which serve as security for the loan. The risk of loan default increases as the value of the underlying securities declines. This risk is actively managed through the use of margin calls on loans when the underlying securities fall below established levels. Overall, the margin lending portfolio is limited to a ratio of borrowed funds to market value of securities of 60%. On November 30, 1999, BT Financial Group margin lending operations securitized its margin lending portfolio with Westpac Banking Corporation, an Australian bank. Under the terms of this financing, BT Financial Group margin lending operations are required to allocate capital equal to approximately 7% of the outstanding borrowed amount, as a cushion for loan defaults. As of June 30, 2001, the margin lending portfolio was \$569.1 million, or A\$1,120.1 million, while the ratio of borrowed funds to market value of securities was 44%, below that of the maximum allowed.

#### FOREIGN CURRENCY RISK

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from our international operations and foreign currency-denominated funding agreements issued to non-qualified institutional investors in the international market. The notional amount of our currency swap agreements associated with foreign-denominated liabilities as of June 30, 2001 was \$3,078.5 million. We also have fixed maturity securities that are denominated in foreign currencies. However, we use derivatives to hedge the foreign currency risk, both interest payments and the final maturity payment, of these funding agreements and securities. As of June 30, 2001, the fair value of our foreign currency denominated fixed maturity securities was \$381.8 million. We use currency swap agreements of the same currency to hedge the foreign currency exchange risk related to these investments. The notional amount of our currency swap agreements associated with foreign-denominated fixed maturity securities as of June 30, 2001 was \$398.5 million. With regard to our international operations, we attempt to do as much of our business as possible in the functional currency of the country of operation. At times, however, we are unable to do so, and in these cases, we use foreign exchange derivatives to hedge the resulting risks.

Additionally, we utilize foreign currency swaps related to \$665.0 million of private notes issued in connection with our acquisition of BT Financial Group. Currently the interest payments related to these notes are serviced through operating cash flows of our Australian operations. By utilizing the foreign currency and interest rate swaps, the impact of Australian dollar and U.S. dollar exchange rate fluctuations have a minimal effect on our ability to rely on the cash flows of our Australian operations to service the interest and principal payments related to the notes.

We estimate that as of June 30, 2001, a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we are exposed would result in no material change to the net fair value of our foreign currency denominated instruments identified above, including the currency swap agreements. The selection of a 10% immediate unfavorable change in all currency exchange rates should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event. Our largest individual currency exposure is to fluctuations between the Australian dollar and the U.S. dollar.

#### EFFECTS OF INFLATION

We do not believe that inflation, in the United States or in the other countries in which we operate, has had a material effect on our consolidated operations over the past five years. In the future, however, we may be affected by inflation to the extent it causes interest rates to rise. See "Risk Factors -- Our efforts to reduce the impact of interest rate changes on our profitability and surplus may not be effective".



## BUSINESS

The Principal Financial Group is a leading provider of retirement savings, investment and insurance products and services, with \$116.9 billion in assets under management and approximately thirteen million customers worldwide as of June 30, 2001. Our U.S. and international operations concentrate primarily on asset management and accumulation. In addition, we offer a broad range of individual life and disability insurance, group life and health insurance, and residential mortgage loan origination and servicing in the United States.

We provide a comprehensive portfolio of asset accumulation products and services to businesses and individuals in the United States, with a concentration on small and medium-sized businesses, which we define as businesses with less than 1,000 employees. We place a particular emphasis on businesses with less than 500 employees. We offer to businesses products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans and non-qualified executive benefit plans. We also offer annuities, mutual funds and bank products and services to the employees of our business customers and other individuals.

We provided services to more 401(k) plans in the United States in 2000 than any other bank, mutual fund or insurance company, according to surveys conducted by CFO magazine. From 1998 to 2000, our 401(k) assets under management increased 20% and our plan participants increased 8%. Within the 401(k) market for businesses with less than 500 employees, we had the leading market share in 2000 based on number of plans (8.5%) and number of participants (11.3%) and the third largest market share based on assets under management (6.6%), according to the Spectrem Group. We believe that the 401(k) market has strong growth potential. The Spectrem Group projects that assets under all 401(k) plans in the United States will grow at a compound annual rate of 14.0%, reaching \$3.2 trillion in plan assets by 2006. The small and medium-sized business market remains under-penetrated with only 18% of U.S. businesses with less than 500 employees offering a 401(k) plan in 2000. Accordingly, we believe that we are uniquely positioned to capitalize on the growth opportunities in the 401(k) plan and other defined contribution pension plan markets in the United States and internationally.

Principal Capital Management, our U.S.-based asset manager, provides asset management services to our U.S. asset accumulation businesses and third-party institutional clients, as well as our other segments. We established Principal Capital Management in 1999 to consolidate our extensive investment management expertise and to focus on marketing our asset management services to third-party institutional clients. We believe that Principal Capital Management is well-positioned to compete in this third-party institutional market through its expertise gained from managing a significant percentage of the assets originating from our U.S. asset accumulation operations. As of June 30, 2001, Principal Capital Management managed \$84.0 billion in assets, of which \$5.8 billion, or 7%, represented assets managed directly for third-party institutional clients.

Our acquisition of BT Financial Group in 1999 was a central element in the expansion of our international asset management and accumulation businesses. As of June 30, 2001, BT Financial Group was the fifth largest asset manager in Australia according to ASSIRT. As of June 30, 2001, BT Financial Group had accumulated \$22.6 billion of assets under management and provided investment advisory services to \$21.1 billion in assets. We believe that the mandated retirement savings system in Australia, called superannuation, and BT Financial Group's strong market position, together with the expertise we have developed in the U.S. defined contribution pension plan market, should provide for growth in our assets under management in Australia. BT Financial Group and Principal Capital Management together enhance our ability to compete in global asset management.

The activities of Principal International reflect our efforts to capitalize on the trend toward private sector defined contribution pension systems. We believe that this trend offers significant potential for future growth. We also believe that the expertise we have developed in serving the U.S. pension plan market enables us to take advantage of these opportunities. Through Principal International, we offer retirement products and services, annuities, mutual funds and life insurance. We operate through subsidiaries in Argentina, Chile, Mexico and Hong Kong and joint ventures in Brazil, Japan and India.

Our Life and Health Insurance segment offers individual life and disability insurance as well as group life and health insurance throughout the United States. Our individual life and disability insurance business served approximately 750,000 policyholders with \$81.8 billion of life insurance in force as of June 30, 2001. Our individual insurance products include interest-sensitive life, traditional life and disability insurance. Our group insurance business served approximately 80,000 employers covering approximately 5.0 million members and had \$70.7 billion of group life insurance in force as of June 30, 2001. Our group insurance products include life, disability, medical, dental and vision insurance, and administrative services.

Our Mortgage Banking segment engages in originating, purchasing, selling and servicing residential mortgage loans in the United States. We service a majority of the loans that we originate. We originated or purchased \$15.4 billion in new mortgage loans for the six months ended June 30, 2001, compared to \$8.3 billion for the year ended December 31, 2000. We serviced a portfolio of \$64.4 billion of mortgage loans as of June 30, 2001. Residential mortgages represent a component of our overall portfolio of market-driven financial products and services.

ASSETS UNDER MANAGEMENT BY SEGMENT

For management and financial reporting purposes, we organize our businesses into four operating segments:

- U.S. Asset Management and Accumulation;
- International Asset Management and Accumulation;
- Life and Health Insurance; and
- Mortgage Banking.

We also have a Corporate and Other segment which consists of the assets and activities that have not been allocated to any other segment.

One of the primary measures of our businesses is assets under management. We define "assets under management" as any assets on which we earn an asset-based fee or a spread. Fee-based products, such as mutual funds, provide no investment guarantee to the customer and provide us the potential for higher returns on our capital. Customer deposits in fee-based investments are either included in our separate accounts or do not appear on our balance sheet. The investment results of the separate account assets generally pass through to the separate account policyholders and contractholders, less management fees, so that we bear limited or no investment risk on such assets. Spread-based products, such as guaranteed investment contracts, provide a guarantee of return to customers for a specified period of time. The spread is the difference between the investment income we earn and the investment income we credit to our customers. We generally report customer deposits in spread-based investments on our balance sheet.

The table below shows by segment the amount of assets on which we earned an asset-based fee as compared to that on which we earned a spread for the periods indicated:

ASSETS UNDER MANAGEMENT  
FEE-BASED/SPREAD-BASED COMPOSITION

	AS OF JUNE 30,			AS OF DECEMBER 31,								
	2001			2000			1999			1998(2)		
	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL
(\$ IN BILLIONS)												
U.S. Asset Management and Accumulation.....	\$47.3	\$31.4	\$ 78.7	\$48.9	\$29.2	\$ 78.1	\$46.9	\$28.7	\$ 75.6	\$38.0	\$29.2	\$67.2
International Asset Management and Accumulation.....	23.0	2.7	25.7	25.6	2.8	28.4	28.4	2.2	30.6	0.3	0.9	1.2
Life and Health Insurance.....	2.0	7.5	9.5	2.1	7.2	9.3	2.0	6.7	8.7	1.3	6.9	8.2
Mortgage Banking(1).....	--	0.3	0.3	--	0.2	0.2	--	0.5	0.5	--	0.7	0.7
Subtotal.....	\$72.3	\$41.9	114.2	\$76.6	\$39.4	116.0	\$77.3	\$38.1	115.4	\$39.6	\$37.7	77.3
Corporate and Other.....			2.7			1.5			1.2			3.1
Total.....			\$116.9			\$117.5			\$116.6			\$80.4

(1) Excludes our mortgage loan servicing portfolio.

(2) Includes assets managed by Invista Capital Management and the former investment department of Principal Life prior to the formation of Principal Capital Management, effective January 1, 1999.

Our primary focus is on asset management and accumulation, with particular emphasis on retirement products and services. We define "asset accumulation" as the sale of investment-oriented products and services for which we provide administrative services and/or offer investment choices from one or more asset managers. Our asset accumulation products and services include pensions, mutual funds, individual annuities and banking products. The fees our customers pay for these products and services are based on the asset balance of the product the customer purchases. We retain a portion of these fees in return for our administrative services and pay a portion to the asset manager, which may be us. We report the asset balances within our asset accumulation operations as assets under management if we earn an asset-based fee or a spread on those assets, regardless of whether our affiliated asset managers manage any of the underlying investment assets.

We define "asset management" as the provision of investment advisory services, including the screening, selection, purchase and ultimate sale of specific financial assets. We refer to the entity that provides these services as an "asset manager." The asset manager may be affiliated with us, such as Principal Capital Management and BT Financial Group, or may be an unaffiliated third-party.

We manage a large majority of assets originating from our asset accumulation operations. The table below shows the assets managed by asset manager:

ASSETS UNDER MANAGEMENT  
BY ASSET MANAGER

	AS OF JUNE 30,	AS OF DECEMBER 31,		
	----- 2001 -----	2000	1999	1998
	----- (\$ IN BILLIONS) -----			
Principal Capital Management.....	\$ 84.0	\$ 83.2	\$ 82.2	\$77.1
BT Financial Group.....	21.1	24.3	28.2	--
Other Entities of the Principal Financial Group.....	4.4	3.7	2.6	1.9
Third-Party Asset Managers.....	7.4	6.3	3.6	1.4
	-----	-----	-----	-----
Total.....	\$116.9	\$117.5	\$116.6	\$80.4
	=====	=====	=====	=====

OUR STRATEGY

Our goal is to enhance stockholder value by pursuing the most attractive financial services opportunities consistent with the capabilities of our asset management and accumulation operations. We intend to accomplish this goal by increasing the growth and profitability of these businesses through the pursuit of the following primary strategic initiatives:

**ACCELERATE THE GROWTH OF OUR U.S. ASSET ACCUMULATION BUSINESS.** We intend to strengthen our existing distribution channels and expand into new distribution channels, further leverage our technology to achieve operating efficiencies, continue to expand the range of investment options and effectively cross-sell our products and services.

**INCREASE THE GROWTH AND PROFITABILITY OF OUR INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION BUSINESS.** We will continue to leverage our U.S. product expertise and operating platform to strengthen our international operations. We seek to accelerate the growth of our assets under management by capitalizing on the international trend toward privatization of public retirement pension systems. In addition, we intend to continue our progress in managing expenses.

**GROW OUR THIRD-PARTY INSTITUTIONAL ASSETS UNDER MANAGEMENT.** We selectively target asset classes and customers in the United States, Australia and globally to capitalize on the specific strengths of Principal Capital Management and BT Financial Group. They jointly execute this strategy in their respective markets and through marketing offices in London, Hong Kong and Singapore.

In addition to these primary strategic initiatives, we have specific strategies within each of our operating segments, which are described in our operating segment discussions.

OPERATING PRINCIPLES

To effectively realize our strategic initiatives, we are implementing the following operating principles:

- operate a full-service platform to serve the needs of our customers;
- build on strong customer relationships;
- focus on our financial performance; and
- reinforce our culture.

OPERATE A FULL-SERVICE PLATFORM

We differentiate ourselves by operating a full-service platform to serve the wide array of our customers' needs by originating sales through our diverse distribution channels, offering a comprehensive portfolio of products and services, administering our products and services efficiently using information technology and managing a significant portion of the assets we accumulate as follows:

**STRENGTHEN OUR DIVERSE DISTRIBUTION CHANNELS.** We originate sales of our products and services through diverse distribution channels that include our retirement services sales representatives, financial representatives, insurance brokers, registered representatives and direct channels such as Principal Connection(SM). We also use other distribution sources particular to each business segment. We intend to strengthen and grow existing distribution channels and to expand into new distribution sources for sales of our products and services. In particular, we realigned our retirement services sales force to focus on new sales, targeted new distribution channels to sell our 401(k) products and services and created Principal Connection, our direct distribution channel to individuals.

OFFER A COMPREHENSIVE PORTFOLIO OF MARKET-DRIVEN PRODUCTS AND SERVICES. We provide a comprehensive portfolio of products and services in the markets in which we operate, as follows:

- We focus on providing full-service asset accumulation products to businesses. We continue to add new investment choices to increase the range of investment styles, asset classes and asset managers we offer to our customers. In addition to our pension products and services, we offer a comprehensive portfolio of life and health insurance products.
- Principal Capital Management and BT Financial Group offer a variety of asset classes and investment styles to institutional investors. In addition, we have developed a collaborative approach between these two firms, whereby the respective strengths and capabilities in asset classes of each investment operation are made available to our customers.
- For our individual customers, including employees of our business customers, we offer variable and fixed individual annuities, retail mutual funds, individual insurance products, residential mortgages and banking products.

USE TECHNOLOGY TO ENHANCE SALES, CUSTOMER SERVICE AND EFFICIENCY. We invest in information technology to achieve continued operational efficiency and to deliver enhanced value to our customers through timely, responsive service and competitive pricing.

- In December 2000, InformationWeek ranked us among the top 25 of the 100 most innovative companies in the United States in building profitable and successful customer relationships, and also profiled Impact401(k).com, our fully electronic 401(k) product through which the plan sponsor can handle the purchase, enrollment and administration of a 401(k) plan entirely through the Internet. We were one of only four financial services companies to achieve a top 25 ranking.
- We are a leader in the use of the Internet to service our customers in the United States. Through our Internet site, we offer customers a "consolidated view" displaying all the Principal Financial Group products they own, including pension plans, insurance policies, mutual funds, bank products and mortgage balance information. Our increasing use of the Internet to provide pension products and services allows us to lower our unit costs and more efficiently serve our customers. For example, the number of transactions processed through Principal Direct Connect, which allows plan sponsors to transfer retirement data via the Internet, has increased from approximately 23.0 million in 1999 to approximately 84.6 million in 2000. For the six months ended June 30, 2001, approximately 65.0 million transactions were processed through Principal Direct Connect.
- We seek to leverage technology developed for our U.S. operations into our international operations. We currently utilize a common client/server-based system in most countries, designed to incorporate our expertise from our U.S. systems.

PROVIDE ASSET MANAGEMENT FOR A SIGNIFICANT PORTION OF THE ASSETS WE ACCUMULATE. Principal Capital Management and BT Financial Group manage a large majority of the assets we accumulate. By offering investment choices that are managed by our affiliated asset managers, we enhance our ability to retain the asset management fees that would otherwise be paid to third-party asset managers.

#### BUILD ON STRONG CUSTOMER RELATIONSHIPS

We are committed to building on our strong customer relationships by providing products and services that respond to their needs and by increasing the global awareness of our brand.

RESPOND TO THE NEEDS OF OUR CUSTOMERS. One of our core values is customer focus, and we place priority on understanding and meeting their needs. We conduct ongoing market research to monitor customer needs and preferences. We offer a comprehensive portfolio of products and services, provide a wide range of choices of investment styles, asset classes and asset managers, and utilize technology built around the customer's needs and desires. We continue to expand our product portfolio to continue to meet the changing needs of our customers. We also use a variety of relationship-building tools, including financial counseling, a financial education magazine, investment education materials, account statements and our Internet website.

INCREASE GLOBAL AWARENESS OF OUR BRAND. We believe brand recognition is particularly important in establishing and maintaining strong relationships with our customers and distributors. Therefore, we have made a substantial effort to establish the "Edge" triangle as a widely recognized logo in the United States and the other countries in which we operate. To develop awareness of our brand, we have maintained high-visibility advertising and event sponsorships, such as the Olympics and the Super Bowl. For example, during the 2000 Olympic Summer Games, we launched a new advertising campaign, "we understand what you are working for," designed to enhance recognition and leverage our brand to attract new customers. The Mobius Advertising Awards honored us in February 2001 with its Mobius Award. We received a first-place award in the financial services category for our 2000 "Happy People" print advertising campaign.

## FOCUS ON FINANCIAL PERFORMANCE

We have taken specific actions to improve our operating earnings over the last several years, and we intend to continue to focus each of our businesses to further improve financial performance. We reported record operating earnings for 2000, with an operating return on average equity of 10.5%. We believe our financial performance will further improve if we continue to:

- manage capital effectively;
- improve cost management; and
- actively manage our investment portfolio.

**MANAGE CAPITAL EFFECTIVELY.** We believe that effective management of capital is essential to creating stockholder value. This consists of assessing the near-term financial impact and the long-term attractiveness of each of our businesses, as well as the appropriateness of share repurchases. We have already taken the following initiatives:

- We increased the discipline in our capital allocation process. Our goal is to improve profitability by increasing our focus on, and capital allocation to, asset management and accumulation products and services which offer us a potential for higher returns on our capital, such as fee-based products.
- We exited under-performing and non-strategic businesses and markets, including: the HMO business; several other group medical insurance businesses; our retail securities brokerage operations; our pre-retirement asset accumulation business in Argentina; and our operations in Spain.
- We have focused our international operations and investments in countries that we believe offer the greatest long-term growth opportunities, favorable demographics and a trend toward private sector defined contribution pension systems. As a result, we operate through subsidiaries in Argentina, Chile, Mexico and Hong Kong, and joint ventures in Brazil, Japan and India.

**IMPROVE COST MANAGEMENT.** We are committed to improving profitability by actively managing our operating expenses. We seek to achieve further operating leverage through increased operating efficiencies. We have made significant investments in technology to enhance the efficiency of our operations, particularly in the area of customer service and transaction processing. For example, our annualized full-service pension transactions per U.S. employee rose from 11,926 in 1998 to 16,026 for the six months ended June 30, 2001.

**ACTIVELY MANAGE OUR INVESTMENT PORTFOLIO.** Over the past three years, we rebalanced our investment portfolio by reducing our exposure to equity securities and real estate. We reoriented the portfolio toward investments that produce higher current investment income, rather than those that produce long-term capital gains that had historically been the focus of our investment activities as a mutual life insurance company. In addition to reducing our portfolio risk profile, we will continue to manage our investment portfolio to achieve higher yields consistent with our risk management strategy.

## REINFORCE OUR CULTURE

We are committed to strengthening our organization's performance-oriented culture. The following are three specific activities that support this objective:

- We have a new incentive compensation program for our senior management designed to align compensation with individual and company-wide performance measures. We refined our performance review program to increase individual accountability and better align individual and corporate goals toward profitable growth.
- We adopted a balanced scorecard for our employees to measure their performance from four perspectives: financial results; customer relations; internal process and learning and growth. Our balanced scorecard links performance in these areas to salary, establishes accountability, focuses employees on common goals and helps employees see how their contributions can affect our financial results.
- Upon demutualization, a stock option plan designed to encourage broad-based employee ownership will become effective. We believe this plan will advance the interests of our stockholders by enhancing our ability to attract, retain and motivate individuals who make important contributions to our company. We also believe that employee equity ownership opportunities and performance-based incentives will closely align the interests of our employees with those of our stockholders.

SEGMENT OVERVIEW

The table below provides a summary of the markets targeted, the distribution channels used and the products and services offered by each of our operating segments:

U.S. ASSET MANAGEMENT AND ACCUMULATION		
MARKETS	DISTRIBUTION	PRODUCTS/SERVICES
<p>Asset Accumulation</p> <ul style="list-style-type: none"> <li>- Businesses, their employees and other individuals</li> <li>- Not-for-profit organizations</li> <li>- Large financial institutions and employers for our guaranteed investment contracts, funding agreements and institutional mutual funds</li> </ul>	<ul style="list-style-type: none"> <li>- Retirement services sales representatives</li> <li>- Institutional marketers</li> <li>- Affiliated financial representatives</li> <li>- Affiliated and unaffiliated registered representatives</li> <li>- Independent brokers</li> <li>- Principal Connection</li> </ul>	<ul style="list-style-type: none"> <li>- Pension</li> <li>- Full-service accumulation</li> <li>- Full-service payout</li> <li>- Investment-only</li> <li>- Administration-only</li> <li>- Mutual funds</li> <li>- Individual annuities</li> <li>- Banking</li> </ul>
<p>Principal Capital Management</p> <ul style="list-style-type: none"> <li>- Large U.S. corporate, private and Taft-Hartley pension funds</li> <li>- U.S. endowments and foundations</li> <li>- Sub-advisory relationships with non-affiliated financial institutions</li> <li>- Non-US institutions (in collaboration with BT Financial Group)</li> <li>- Real estate development</li> <li>- Securitization markets</li> </ul>	<ul style="list-style-type: none"> <li>- Institutional marketers</li> <li>- Consultants</li> </ul>	<ul style="list-style-type: none"> <li>- Institutional and retail money management in:</li> <li>- Domestic equities</li> <li>- International equities</li> <li>- Fixed income</li> <li>- Commercial real estate</li> </ul>
INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION		
MARKETS	DISTRIBUTION	PRODUCTS/SERVICES
<p>BT Financial Group</p> <ul style="list-style-type: none"> <li>- Corporate superannuation funds</li> <li>- Businesses, their employees and other individuals</li> <li>- Australian and non-Australian institutions</li> <li>- Financial intermediaries</li> </ul>	<ul style="list-style-type: none"> <li>- Consultants</li> <li>- Financial intermediaries (financial advisors, accountants and solicitors)</li> <li>- Institutional marketers</li> <li>- Direct distribution to customers</li> </ul>	<ul style="list-style-type: none"> <li>- Institutional and retail money management</li> <li>- Mutual funds</li> <li>- Corporate superannuation products</li> <li>- Processing and transaction services for financial planners, financial intermediaries and companies</li> <li>- Margin lending</li> </ul>
<p>Principal International</p> <ul style="list-style-type: none"> <li>- Businesses, their employees and other individuals</li> </ul>	<ul style="list-style-type: none"> <li>- Distribution appropriate to each country and market, for example:</li> <li>- Dedicated retirement services sales forces in Mexico and Hong Kong</li> <li>- Financial institutions in Brazil through the branches of Banco do Brasil</li> <li>- Unaffiliated brokers in Chile</li> </ul>	<ul style="list-style-type: none"> <li>- Retirement services</li> <li>- Brazil</li> <li>- Hong Kong</li> <li>- India</li> <li>- Japan</li> <li>- Mexico</li> <li>- Annuities and life insurance</li> <li>- Argentina</li> <li>- Chile</li> <li>- Mexico</li> </ul>
LIFE AND HEALTH INSURANCE		
MARKETS	DISTRIBUTION	PRODUCTS/SERVICES
<p>Individual Life and Disability Insurance</p> <ul style="list-style-type: none"> <li>- Businesses, their employees and other individuals</li> </ul>	<ul style="list-style-type: none"> <li>- Affiliated financial representatives</li> <li>- Independent brokers</li> <li>- Affiliated and unaffiliated registered representatives</li> <li>- Disability sales representatives</li> </ul>	<ul style="list-style-type: none"> <li>- Individual insurance</li> <li>- Interest-sensitive life</li> <li>- Traditional life</li> <li>- Disability</li> </ul>

LIFE AND HEALTH INSURANCE

MARKETS	DISTRIBUTION	PRODUCTS/SERVICES
Group Life and Health Insurance - Businesses	- Group sales representatives - Rogers Benefit Group sales representatives - Non-medical sales representatives	- Group life - Group disability - Group medical - Group dental and vision - Fee-for-service

MORTGAGE BANKING

MARKETS	DISTRIBUTION	PRODUCTS/SERVICES
- Individuals	- Correspondent lending institutions - Mortgage loan officers (retail origination) - Regional offices that work directly with approved mortgage loan brokers (wholesale) - Mortgage Direct	- Originate, purchase, sell and service prime credit quality, first-lien residential mortgage loans

U.S. ASSET MANAGEMENT AND ACCUMULATION SEGMENT

Our U.S. Asset Management and Accumulation segment consists of:

- asset accumulation operations which provide retirement savings and related investment products and services to businesses, their employees and other individuals; and
- Principal Capital Management, our U.S.-based asset manager.

Our U.S. Asset Management and Accumulation segment contributed 41%, 41%, 42% and 38% of our total operating revenues and 48%, 57%, 75% and 89% of our total operating earnings for the six months ended June 30, 2001, and the years ended December 31, 2000, 1999 and 1998, respectively.

The table below shows the operating revenues, operating earnings, assets and assets under management of our U.S. Asset Management and Accumulation segment for the periods indicated:

U.S. ASSET MANAGEMENT AND ACCUMULATION  
SELECTED FINANCIAL HIGHLIGHTS

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,					
	2001		2000	1999	1998(4)			
(\$ IN MILLIONS)								
<b>OPERATING REVENUES(1)</b>								
U.S. Asset Accumulation.....	\$ 1,780.5	96%	\$ 3,398.1	96%	\$ 3,348.1	96%	\$ 2,933.1	100%
Principal Capital Management.....	96.3	5	174.2	5	156.6	5	--	--
Intra-segment eliminations(2).....	(18.6)	(1)	(38.4)	(1)	(32.1)	(1)	--	--
Total.....	\$ 1,858.2	100%	\$ 3,533.9	100%	\$ 3,472.6	100%	\$ 2,933.1	100%
<b>OPERATING EARNINGS:</b>								
U.S. Asset Accumulation.....	\$ 159.0	90%	\$ 317.6	89%	\$ 321.2	90%	\$ 238.4	100%
Principal Capital Management.....	17.9	10	39.0	11	35.4	10	--	--
Total.....	\$ 176.9	100%	\$ 356.6	100%	\$ 356.6	100%	\$ 238.4	100%
<b>ASSETS:</b>								
U.S. Asset Accumulation.....	\$65,155.9	98%	\$64,883.9	99%	\$64,410.4	99%	\$58,701.5	100%
Principal Capital Management.....	1,026.5	2	912.0	1	686.0	1	--	--
Total.....	\$66,182.4	100%	\$65,795.9	100%	\$65,096.4	100%	\$58,701.5	100%
<b>ASSETS UNDER MANAGEMENT:</b>								
(\$ in billions)								
U.S. Asset Accumulation.....	\$ 71.9	91%	\$ 71.0	91%	\$ 70.3	93%	\$ 63.5	94%
Principal Capital Management(3).....	6.8	9	7.1	9	5.3	7	3.7	6
Total.....	\$ 78.7	100%	\$ 78.1	100%	\$ 75.6	100%	\$ 67.2	100%

(1) Excludes net realized capital gains and their impact on recognition of





- (2) Includes eliminations of amounts related to U.S. asset management fee revenues received from our U.S. asset accumulation operations.
- (3) Represents \$5.8 billion, \$6.3 billion, \$4.7 billion and \$3.5 billion of assets from third-party clients as of June 30, 2001 and as of December 31, 2000, 1999 and 1998, respectively, with the remainder representing assets supporting other Principal Capital Management activities. Assets accumulated by other affiliates are shown under the business which accumulated the assets.
- (4) Includes assets managed by Invista Capital Management and the former investment department of Principal Life prior to the formation of Principal Capital Management, effective January 1, 1999.

#### U.S. ASSET ACCUMULATION

Our asset accumulation activities in the United States date back to the 1940s when we first began providing pension plan products and services. We now offer a comprehensive portfolio of asset accumulation products and services for retirement savings and investment:

- To businesses of all sizes, we offer products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans and non-qualified executive benefit plans. For more basic needs, we offer our mutual funds as a funding vehicle for SIMPLE IRA, payroll deduction, 401(k) and 403(b) plans;
- To large institutional clients, we also offer investment-only products, including guaranteed investment contracts and funding agreements; and
- To employees of businesses and other individuals, we offer the ability to accumulate retirement savings through mutual funds, individual annuities and bank products.

We organize our U.S. asset accumulation operations in the following product and service categories:

- pension;
- mutual funds;
- individual annuities; and
- Principal Bank.

We further group our pension products and services into four categories:

- full-service accumulation;
- full-service payout;
- investment-only; and
- administration-only.

The table below shows the operating revenues for our U.S. asset accumulation operations for the periods indicated:

U.S. ASSET ACCUMULATION  
OPERATING REVENUES

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,	
	2001	2000	1999	1998
	(\$ IN MILLIONS)			
Pension				
Full-service Accumulation.....	\$ 530.1	\$1,168.1	\$1,178.2	\$1,185.8
Full-service Payout.....	547.1	920.6	929.0	643.6
Investment-Only.....	494.7	881.7	833.8	715.9
Administration-Only.....	19.1	42.3	39.3	36.8
Mutual Funds.....	56.1	116.0	95.4	83.5
Individual Annuities.....	132.7	267.5	270.2	267.2
Principal Bank.....	10.1	9.2	2.2	0.3
Eliminations.....	(9.4)	(7.3)	--	--
U.S. Asset Accumulation.....	\$1,780.5	\$3,398.1	\$3,348.1	\$2,933.1

The table below breaks down the assets under management for our U.S. asset accumulation operations between those derived from fee-based products and those derived from spread-based products for the periods indicated:

U.S. ASSET ACCUMULATION  
ASSETS UNDER MANAGEMENT(1)  
FEE-BASED/SPREAD-BASED COMPOSITION

	AS OF JUNE 30,			AS OF DECEMBER 31,								
	2001			2000			1999			1998		
	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL
	(\$ IN BILLIONS)											
Pension.....	\$35.2	\$27.2	\$62.4	\$36.0	\$25.7	\$61.7	\$35.7	\$25.6	\$61.3	\$29.3	\$25.9	\$55.2
Mutual Funds.....	3.8	--	3.8	3.9	--	3.9	4.1	--	4.1	3.7	--	3.7
Individual Annuities.....	2.3	2.5	4.8	2.3	2.5	4.8	2.3	2.6	4.9	1.5	3.1	4.6
Principal Bank.....	--	0.9	0.9	0.3	0.3	0.6	--	--	--	--	--	--
U.S. Asset Accumulation....	\$41.3	\$30.6	\$71.9	\$42.5	\$28.5	\$71.0	\$42.1	\$28.2	\$70.3	\$34.5	\$29.0	\$63.5

(1) Assets under management are credited to the operations that accumulated the assets.

The table below shows the asset flow summary for our U.S. asset accumulation operations for the periods indicated:

U.S. ASSET ACCUMULATION  
ASSET FLOW SUMMARY

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,	
	2001	2000	1999	
	(\$ IN BILLIONS)			
Assets Under Management, beginning of period.....	\$71.0	\$ 70.3	\$ 63.5	
Deposits.....	8.9	14.6	14.7	
Withdrawals.....	(6.6)	(14.3)	(11.9)	
Investment Performance.....	(0.9)	1.0	5.6	
Other.....	(0.5)	(0.6)	(1.6)	
Assets Under Management, end of period.....	\$71.9	\$ 71.0	\$ 70.3	

The table below illustrates the various distribution channels used by our U.S. asset accumulation operations:

U.S. ASSET ACCUMULATION  
DISTRIBUTION

	RETIREMENT SERVICES SALES REPRESENT- ATIVES	AFFILIATED FINANCIAL REPRESENT- ATIVES	REGISTERED REPRESENT- ATIVES	INDEPENDENT BROKERS	PRINCIPAL CONNECTION	INTERNET	BANKS
Pension.....	X	X	X	X	X	X	
Mutual Funds.....	X	X	X	X	X		
Individual Annuities.....		X		X	X		X
Principal Bank.....	X	X	X		X	X	

STRATEGY

Our goal is to enhance our position as a leading provider of asset accumulation products and services to businesses in the United States, particularly small and medium-sized businesses. To achieve this goal, we are pursuing the following strategic initiatives:

ACCELERATE THE GROWTH OF OUR U.S. ASSET ACCUMULATION OPERATIONS BY LEVERAGING OUR STRENGTH IN PROVIDING RETIREMENT SERVICES TO SMALL AND MEDIUM-SIZED BUSINESSES. Our current success is built on our strong position in the defined contribution pension plan market, in particular the 401(k) market, to which we provided services to more 401(k) plans than any other bank, mutual fund or insurance company in 2000.

In particular, we have taken the following actions to achieve continued leadership and growth in this market:

Strengthen our distribution channels. We are committed to building on our existing distribution channels, as well as expanding into new distribution channels:

- We have increased the focus of our retirement services sales representatives on new sales of pension products. We have shifted the responsibility for servicing our customers from our retirement services sales representatives to a dedicated customer service staff and centralized many of the administrative functions related to our pension products in regional market centers. In addition, we now compensate our retirement services sales representatives with a greater emphasis on new sales of products instead of renewals of existing contracts.
- We have also targeted new distribution channels for sales of our products and services, including third-party administrators, certified public accountants, registered investment advisors, registered representatives of other broker-dealers and direct sales through the Internet. For example, we have introduced a new 401(k) product, Principal Advantage, funded by mutual funds. Principal Advantage is targeted at non-affiliated distribution channels such as registered investment advisors and broker-dealers. We have also introduced Impact401k.com, our self-service Internet site. This pension product is targeted at smaller businesses that seek a low cost product, as well as businesses of any size that prefer to handle all administrative activities through the Internet.

Provide customers with new investment choices. We added new investment choices that increased the range of investment styles, asset classes and asset managers of our offerings. These additional choices complement those offered by Principal Capital Management. We also offer self-directed brokerage accounts to 401(k) plan participants.

Continue to use technology to enhance sales, customer service and efficiency. Our increasing use of the Internet as a tool to give plan sponsors and plan participants access to information and the ability to administer their defined contribution plans has resulted in significant productivity gains. We have undertaken the following technology initiatives to allow us to better serve the small and medium-sized business market and to enhance the quality and efficiency of our U.S. pension operations:

- Since its inception in 1998, Principal Direct Connect has become a preferred means for our pension plan sponsors to transfer retirement data via the Internet and to execute transactions online. The number of transactions processed through Principal Direct Connect has increased from approximately 23.0 million in 1999 to approximately 84.6 million in 2000. For the six months ended June 30, 2001, approximately 65.0 million transactions were processed through Direct Connect;
- In 1998, we developed a customer workflow and processing system, Express Processing(SM), to support our full-service pension plan administration. This technology enables us to achieve significant efficiencies by automatically moving workflow to (1) employees with the correct skill-set to efficiently process the work and (2) any of five administration facilities in the United States with the greatest capacity;

- We have structured the "Retirement Service Center" portion of our Internet website as a full-service center through which plan sponsors and plan participants can access their complete plan information. During 2000, participants made approximately 7.7 million visits to our Retirement Service Center, resulting in approximately 5.9 million electronic transactions. For the six months ended June 30, 2001, participants made approximately 4.4 million visits, resulting in approximately 2.9 million electronic transactions; and
- In April 2000, we launched what we believe is one of the first fully electronic 401(k) products, Impact401k.com. Through Impact401k.com, the plan sponsor can handle the purchase, enrollment and administration of a 401(k) plan entirely through the Internet without use of paper forms, the mail or the administrative assistance of our employees.

**ENHANCE OUR ASSET RETENTION AND CROSS-SELLING.** In 1997, we created Principal Connection, a direct response distribution channel for retail financial services products to individuals. Principal Connection's services are available over the phone, on the Internet or by mail. As of June 30, 2001, Principal Connection had 48 professionally licensed sales counselors trained to sell our products, answer questions regarding the customer's existing financial product choices and help the customer meet specific financial needs. Through Principal Connection, we seek to retain a significant portion of the assets that pension plan participants normally roll over into a different accumulation or payout product upon retirement or termination of employment. Of the \$2.3 billion of assets eligible for rollover for the six months ended June 30, 2001, we retained \$1.1 billion, or 48%, up from 30% in 1996. Through Principal Connection, we also seek to cross-sell our products and services to pension plan participants and banking and mortgage banking customers.

**MAINTAIN OUR POSITION IN THE INVESTMENT-ONLY PENSION MARKET.** We have been a long-time participant in the investment-only pension market, which emphasizes the sale of guaranteed investment contracts, funding agreements and other investment-only products. We have capitalized on our strong claims paying and financial strength ratings, investment advisory expertise and asset-liability management expertise we offer to customers seeking investment-only pension services. We intend to remain a participant in this market to an extent consistent with our expected returns.

**IMPROVE OUR POSITION IN THE PENSION MARKET FOR LARGER EMPLOYERS.** We have an advantage over many of our competitors in the larger employer pension market since we offer both defined benefit and defined contribution plan services. Many large employers offer both defined benefit and defined contribution plans to their employees and prefer pension services providers that deliver consolidated services to both plans. We are currently expanding the scope of our services to offer:

- employer-customized websites;
- a more flexible billing process;
- consulting services to existing retirement plan customers involved in mergers and acquisitions; and
- customized service through regional customer relations managers dedicated to serving large customers.

#### PENSION

We offer a wide variety of investment and administrative products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans and non-qualified executive benefit plans. A 403(b) plan is a plan described in section 403(b) of the Internal Revenue Code that provides retirement benefits for employees of tax exempt organizations and public schools.

#### PENSION SERVICES

We provide products and services responding to a broad range of employer-sponsored pension plan needs. We offer administrative and investment services, which are both available on a stand-alone basis or can be combined according to the various needs of our customers.

**ADMINISTRATIVE SERVICES.** We believe that our ability to minimize the plan sponsor's administrative tasks has contributed to our success, particularly among small and medium-sized businesses. We differentiate ourselves from our competitors by providing every plan administrative service that is generally required or desired by a pension plan sponsor, regardless of the type or size of the plan.

The table below describes the primary administrative services that we offer to both plan sponsors and plan participants in defined contribution plans and defined benefit plans, as of June 30, 2001:

	SERVICES OFFERED TO PLAN SPONSORS -----	SERVICES OFFERED TO PLAN PARTICIPANTS -----
DEFINED CONTRIBUTION PLANS	<ul style="list-style-type: none"> <li>- Government compliance and documentation</li> <li>- Fund accounting</li> </ul>	<ul style="list-style-type: none"> <li>- Account recordkeeping</li> <li>- Education and reporting</li> <li>- Phone center</li> <li>- Internet access and transaction capabilities</li> <li>- Voice response system</li> <li>- Benefit planning and benefit distribution</li> </ul>
DEFINED BENEFIT PLANS	<ul style="list-style-type: none"> <li>- Actuarial valuation services</li> <li>- Government compliance and documentation</li> <li>- Fund accounting</li> </ul>	<ul style="list-style-type: none"> <li>- Benefit determination and benefit distribution</li> <li>- Education and reporting</li> <li>- Phone center</li> <li>- Internet access and transaction capabilities</li> </ul>

**INVESTMENT SERVICES.** We provide a full range of guaranteed investment contracts, money market, equity, fixed income, balanced, indexed and real estate investment options to our customers. We provide these services through our affiliated asset managers, Principal Capital Management and BT Financial Group, and through third-party asset managers. As of June 30, 2001, we had approximately 220 investment options available, including U.S. and international fixed income and equity investment options. Our investment options are either in the form of a separate account or a mutual fund.

**PENSION PRODUCTS**

We group our pension products into four categories:

- full-service accumulation;
- full-service payout;
- investment-only; and
- administration-only.

Our full-service accumulation products and our full-service payout products feature both administrative services and investment services. We focus primarily on our full-service accumulation and full-service payout products, which together represented 64% of our pension gross new deposits under management for the six months ended June 30, 2001, and 75% of our pension assets under management as of June 30, 2001.

The tables below show, by product category, our pension assets under management, pension asset flow summary and our pension gross new deposits under management for the periods indicated:

**U.S. ASSET ACCUMULATION  
PENSION ASSETS UNDER MANAGEMENT**

	AS OF JUNE 30, ----- 2001 -----	AS OF DECEMBER 31, ----- 2000      1999      1998 -----		
	(\$ IN BILLIONS)			
Full-service Accumulation.....	\$41.2	\$42.0	\$43.3	\$38.5
Full-service Payout.....	5.4	4.5	4.3	3.9
Investment-Only.....	15.8	15.2	13.7	12.8
Administration-Only.....	--	--	--	--
Total.....	\$62.4 =====	\$61.7 =====	\$61.3 =====	\$55.2 =====

U.S. ASSET ACCUMULATION  
PENSION ASSET FLOW SUMMARY

	AS OF OR FOR	AS OF OR FOR THE	
	THE SIX MONTHS	YEAR ENDED	
	ENDED JUNE 30,	DECEMBER 31,	
	2001	2000	1999
	-----		
	(\$ IN BILLIONS)		
Assets Under Management, beginning of period.....	\$61.7	\$61.3	\$55.2
Deposits.....	7.6	12.2	12.9
Withdrawals.....	(5.7)	(12.4)	(10.2)
Investment Performance.....	(0.6)	0.9	5.4
Other.....	(0.6)	(0.3)	(2.0)
	-----		
Assets Under Management, end of period.....	\$62.4	\$61.7	\$61.3
	=====	=====	=====

U.S. ASSET ACCUMULATION  
PENSION GROSS NEW DEPOSITS UNDER MANAGEMENT

	FOR THE SIX	FOR THE YEAR ENDED		
	MONTHS ENDED	DECEMBER 31,		
	JUNE 30,	2000	1999	1998
	2001			
	-----			
	(\$ IN BILLIONS)			
Full-service Accumulation.....	\$4.6	\$ 8.1	\$ 8.2	\$ 7.5
Full-service Payout.....	0.3	0.5	0.6	0.3
Investment-Only.....	2.7	3.6	4.1	3.4
Administration-Only.....	--	--	--	--
	-----			
Total.....	\$7.6	\$12.2	\$12.9	\$11.2
	=====	=====	=====	=====

FULL-SERVICE ACCUMULATION. Full-service accumulation products respond to the needs of plan sponsors seeking both administrative and investment services for defined contribution plans or defined benefit plans. The investment component of our defined contribution plans may be in the form of a group annuity contract or a mutual fund. The investment component of our defined benefit plans is available only in the form of a group annuity contract.

As of June 30, 2001, we provided full-service accumulation products to 34,087 defined contribution pension plans, of which 26,545 were 401(k) plans, covering 2.0 million plan participants, and to 3,404 defined benefit pension plans, covering 238,293 plan participants. As of June 30, 2001, approximately 92% of our pension assets under management were managed by Principal Capital Management or BT Financial Group. Third-party asset managers provide asset management services with respect to the remainder of the assets.

Prior to 2001, annuities were the only product through which we delivered both administrative and investment services to our defined contribution plan and defined benefit plan customers. Under U.S. federal securities laws, neither the annuity nor the underlying investment options are required to be registered with the SEC. Beginning January 2001, we began to offer administrative and investment services to defined contribution plan customers through Principal Advantage, a new 401(k) product based on our recently expanded mutual fund, Principal Investors Fund. We offer funds covering the full range of stable value, equity, fixed income and non-domestic investment options managed by our affiliated asset managers, Principal Capital Management and BT Financial Group, as well as third-party asset managers.

FULL-SERVICE PAYOUT. Full-service payout products respond to the needs of pension plan participants who, upon retirement or termination of their employment, leave their pension plans, and who seek both administrative and investment services for distributions from the plans they are leaving. Plan participants who seek these services include those departing pension plans we service, as well as pension plans other providers service. We offer both flexible income option products and single premium group annuities. Flexible income option products allow the customer to control the rate of distribution, or payout, and provide limited performance guarantees. Single premium group annuities are immediate or deferred annuities that provide a current or future specific income amount, fully guaranteed by us. Both products are available to defined contribution and defined benefit plan participants. For both products, we make regular payments to individuals, invest the underlying assets on their behalf and provide tax reporting to them.

Single premium group annuities are traditionally used in conjunction with defined benefit plans, particularly those where the plan is being terminated. In such instances, the plan sponsor transfers all its obligations under the plan to an insurer by paying a single premium. Increasingly, these products are purchased by defined contribution plan participants who reach retirement age. Plan sponsors restrict their purchases to insurance companies with superior or



excellent financial quality ratings because the Department of Labor has mandated that annuities be purchased only from the "safest available" insurer. We believe that our strong financial strength ratings position us well to compete in this market. See "-- Ratings" below. In 2000, we received \$498.3 million of single premium group annuities annualized new deposits, ranking us second in the United States according to LIMRA International, Inc.'s 2000 U.S. Institutional Pension Sales and Assets report.

Deposits to full-service payout products are in the form of single payments. As a result, the level of new deposits can fluctuate depending on the number of retirements and large-scale annuity sales in a particular fiscal quarter. Assets under management relating to single premium group annuities generate a spread between the investment income earned by us and the amount credited to the customer. Assets under management relating to flexible income option products may generate either spread or fee revenue depending on the investment options elected by the customer.

INVESTMENT-ONLY. The three primary products for which we provide investment-only services are: (1) guaranteed investment contracts; (2) funding agreements; and (3) other investment-only products.

Guaranteed investment contracts and funding agreements pay a specified rate of return. The rate of return can be a floating rate based on an external market index or a fixed rate. Some of these investment-only products provide a feature which permits plan participants to redeem or transfer funds in their accounts at book value during the term of the contract. All of our investment-only products contain provisions limiting early surrenders, including penalties for early surrenders and minimum notice requirements. Put provisions give customers the option to terminate a contract prior to maturity, provided they give us a minimum notice period.

The table below breaks down by notice period the put provisions of our guaranteed investment contracts and funding agreements:

U.S. ASSET ACCUMULATION  
PENSION GUARANTEED INVESTMENT CONTRACTS AND FUNDING AGREEMENTS  
GAAP RESERVES PUT PROVISIONS CHARACTERISTICS  
AS OF JUNE 30, 2001

	GUARANTEED INVESTMENT CONTRACTS	FUNDING AGREEMENTS
	-----	-----
	(\$ IN MILLIONS)	
INVESTMENT-ONLY:		
Less than 30 days' notice.....	\$ --	\$ --
30 to 89 days' notice.....	288.2	100.3
90 to 179 days' notice.....	587.7	220.8
More than 179 days' notice.....	--	55.2
No active put provision(1).....	293.2	
No put provision.....	8,504.8	3,946.6
FULL-SERVICE ACCUMULATION:		
No put provision.....	4,927.3	--
	-----	-----
Total.....	\$14,601.2	\$4,322.9
	=====	=====

-----  
(1) Contracts currently under an initial lock-out period but which will become puttable with 90 days' notice at some time in the future.

Deposits to investment-only products are predominantly in the form of single payments. As a result, the level of new deposits can fluctuate from one fiscal quarter to another. Assets invested in guaranteed investment contracts and funding agreements generate a spread between the investment income earned by us and the amount credited to the customer. Our other investment-only products consist of separate accounts invested in either equities or fixed income instruments.

ADMINISTRATION-ONLY. We provide fee-based administrative services for defined contribution plans, including 401(k) plans, where a third-party provides the investment choices. As of June 30, 2001, we provided administration-only services to 3,829 defined contribution plans covering approximately 198,000 employees. In addition to defined contribution plans, we currently provide administration-only services to 309,686 individual retirement accounts.

MANAGING RISK IN SPREAD-BASED PRODUCTS

Because of the significant guarantees we provide as part of our spread-based asset accumulation products, risk management is particularly important in this line of business. To facilitate risk management, we segregate and manage the assets supporting our spread-based products separately from the rest of our general account. Our risk management strategy is more fully described in "Management's Discussion and Analysis of Financial Condition and



Results of Operations -- Quantitative and Qualitative Information about Market Risk" and is based upon the following guidelines:

- Managing interest rate exposure by closely matching the relative sensitivity of asset and liability values to interest rate changes, i.e. creating a "duration match" of assets and liabilities. Our methodology recognizes both partial and total duration. Our tolerance for mismatch is +/-0.25 years for total duration and +/-0.10 years for partial durations. As of June 30, 2001, the difference between the asset and liability durations on our primary duration managed portfolio was 0.04 years.
- Projecting cash flows for each asset and liability and measuring the sensitivity of assets and liabilities to interest rate changes. This measurement process provides our risk managers with a more complete picture of our liability structure, the appropriateness of pricing and the overall soundness of the management of the account than do conventional accounting techniques alone.
- Restricting the portion of securities with redemption features held in our invested asset portfolio in order to minimize cash flow volatility.
- Writing contracts that typically have a predictable maturity structure and limit discretionary withdrawal provisions. This allows us to better manage our liquidity exposure.
- Monitoring contribution and withdrawal activity to anticipate deviations from expected cash flows. Any such deviations form the basis for new cash flow projections and may trigger a change in our portfolio hedging requirements.
- Conducting studies to test our liquidity tolerance to stress situations such as sudden and intense outflows of cash. We model various "run-on-the-bank" scenarios to evaluate the liquidity needs of our portfolios and ensure that the appropriate amount of liquid assets are held. Based on these results, we believe that we have more than adequate capacity to meet commitments to policyholders.
- Establishing portfolio management groups to facilitate interaction among our various activities, including portfolio management, sales management, risk management, financial management and pricing. We believe frequent interaction and effective communication across the various activities have been key components of our successful risk management strategy.

The table below illustrates, for the periods indicated, gross new deposits under management and reserves for the spread-based products in our U.S. asset accumulation pension operations:

U.S. ASSET ACCUMULATION  
PENSION SPREAD-BASED PRODUCTS SELECTED FINANCIAL DATA

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30, ----- 2001 ----	AS OF OR FOR THE YEAR ENDED DECEMBER 31, ----- 2000      1999      1998 ----- (\$ IN MILLIONS)		
	GROSS NEW DEPOSITS UNDER MANAGEMENT:			
Guaranteed investment contracts.....	\$ 1,454.4	\$ 1,685.2	\$ 3,221.1	\$ 4,720.6
Funding agreements.....	889.9	1,416.0	1,381.0	448.4
Full-service Payout.....	324.6	519.7	562.4	281.0
Total.....	\$ 2,668.9 =====	\$ 3,620.9 =====	\$ 5,164.5 =====	\$ 5,450.0 =====
RESERVES:				
Guaranteed investment contracts.....	\$14,601.2	\$14,700.9	\$15,839.7	\$15,535.8
Funding agreements.....	4,322.9	3,247.4	1,881.9	652.7
Full-service Payout.....	5,012.2	4,762.2	4,390.5	3,951.2
Total.....	\$23,936.3 =====	\$22,710.5 =====	\$22,112.1 =====	\$20,139.7 =====

MARKETS AND DISTRIBUTION

We offer our pension products and services to employer-sponsored pension plans, including qualified and non-qualified defined contribution plans, qualified defined benefit plans and institutional investors. Our primary target market is pension plans sponsored by small and medium-sized businesses, which we believe remains under-penetrated. Only 17% of businesses with less than 100 employees, and 38% of businesses with between 100 and 500 employees, offered a 401(k) plan in 2000, according to the Spectrem Group. The same study indicates that 87% of employers with

500 or more employees offered a 401(k) plan in 2000. The tables below break down, for the periods indicated, the number of plans and assets under management for our full-service accumulation business by employer size:

U.S. ASSET ACCUMULATION  
PENSION FULL-SERVICE ACCUMULATION DATA BY EMPLOYER SIZE

	AS OF JUNE 30,	AS OF DECEMBER 31,		
	2001	2000	1999	1998
<b>NUMBER OF PLANS:</b>				
1-99 employees.....	30,139	29,708	32,656	33,730
100-499 employees.....	3,376	3,236	3,127	3,179
500-999 employees.....	358	347	315	314
1000+ employees.....	214	195	206	182
Number of Defined Contribution Plans.....	34,087	33,486	36,304	37,405
Number of Defined Benefit Plans.....	3,404	3,443	3,592	3,776
Total.....	37,491	36,929	39,896	41,181
Average Number of Employees Per Plan.....	68	67	64	60

	AS OF JUNE 30,	AS OF DECEMBER 31,		
	2001	2000	1999	1998
(\$ IN BILLIONS)				
<b>ASSETS UNDER MANAGEMENT:</b>				
1-99 employees.....	\$16.5	\$16.7	\$17.9	\$15.3
100-499 employees.....	10.1	10.2	10.7	9.5
500-999 employees.....	2.8	3.1	3.1	2.8
1000+ employees.....	5.8	5.6	5.7	4.5
Defined Contribution Assets Under Management.....	35.2	35.6	37.4	32.1
Defined Benefit Assets Under Management.....	6.0	6.4	5.9	6.4
Total.....	\$41.2	\$42.0	\$43.3	\$38.5

**FULL-SERVICE ACCUMULATION.** We sell our full-service accumulation products and services nationally, primarily through a captive retirement services sales force. As of June 30, 2001, 125 retirement services sales representatives in 55 offices, operating as a wholesale distribution network, maintained relationships with approximately 13,000 independent brokers, consultants and agents. Retirement services sales representatives are an integral part of the sales process alongside the referring consultant or independent broker. We compensate retirement services sales representatives through a blend of salary and production-based incentives, while we pay independent brokers, consultants and agents a commission or fee.

As of June 30, 2001, we had a separate staff of 160 service representatives located in the sales offices who play a key role in the ongoing servicing of pension plans by:

- providing local services to our customers, such as renewing contracts, revising plans and solving any administration problems;
- communicating the customers' needs and feedback to us; and
- helping employees understand the benefits of their pension plans.

We believe that our approach to pension plan services distribution gives us a local sales and service presence that differentiates us from many of our competitors. We have also recently established a number of marketing and distribution relationships to increase the sales of our accumulation products with firms such as Frank Russell Investment Management Company, A.G. Edwards and AON.

We sell our annuity-based products through sales representatives, agents and brokers who are not required to register with the SEC.

Principal Advantage, our mutual fund-based product, is targeted at defined contribution plans with over \$3 million of assets. We sell Principal Advantage through affiliated registered representatives, stockbrokers, registered investment advisors and fee-based consultants through sales agreements with non-affiliated broker-dealers. Principal Advantage gives us access to SEC-registered distributors who are not traditional sellers of annuity-based products and opens new opportunities for us in the investment advisor and broker-dealer distribution channels.

We significantly expanded our marketing and product development efforts into the "not-for-profit" market in 1999, with the acquisition of Professional Pensions, Inc., which specializes in providing full-service accumulation



403(b) pension plans to 501(c)(3) not-for-profit organizations. As of June 30, 2001, we provided pension products and services to 778 pension plans sponsored by educational and not-for-profit organizations with \$1,208.6 million of assets under management.

Impact401k.com is our self-service Internet site, through which plan sponsors can handle the purchase, enrollment and administration of a 401(k) pension plan entirely through the Internet. Impact401k.com allows plan participants to gain on-line access to their accounts, transfer funds between accounts and review customized investment options. Accordingly, our employees do not have to perform any administrative activities. Impact401k.com is targeted at smaller businesses that seek a low cost product, as well as businesses of any size that prefer to handle administrative activities through the Internet.

FULL-SERVICE PAYOUT AND INVESTMENT-ONLY. Our primary distribution channel for full-service payout and investment-only products was comprised of 11 specialized home office marketers as of June 30, 2001, working through consultants and brokers that specialize in this type of business. Our home office marketers also make sales directly to institutions. Our nationally dispersed retirement services sales representatives act as a secondary distribution channel for these products. Principal Connection also distributes full-service payout products to participants in plans we service who are terminating employment or retiring.

We market guaranteed investment contracts and funding agreements primarily to pension plan sponsors and other institutions. We also offer them as part of our full-service accumulation products. We sell our guaranteed investment contracts primarily to plan sponsors for funding of tax-qualified retirement plans. We sell our funding agreements to institutions that may or may not be pension funds. Our primary market for funding agreements is institutional investors in the United States and around the world. These investors purchase debt obligations from a special purpose vehicle which, in turn, purchases a funding agreement from us with terms similar to those of the debt obligations. The strength of this market is dependent on debt capital market conditions. As a result, our sales through this channel can vary widely from one fiscal quarter to another.

ADMINISTRATION-ONLY. We sell our defined contribution plan administration-only services primarily through business relationships with investment management firms and insurance companies. These organizations package our administrative services with their proprietary pension plan investment services for sale through their own distribution channels. We have a small number of regional consultants who facilitate the selling of our defined contribution plan administrative services by these organizations. Our administration-only individual retirement account services are distributed by a specialized home office marketer that establishes business relationships with security brokerage firms that offer individual retirement account programs directly to the public.

#### MUTUAL FUNDS

We have been providing mutual funds to customers since 1969. We offer mutual funds:

- to individuals;
- for use within variable life and variable annuity contracts; and
- for use in employer-sponsored pension plans.

#### PRODUCTS AND SERVICES

We were ranked in the top quartile among U.S. mutual fund managers in terms of total mutual fund assets under management as of May 31, 2001, according to the Investment Company Institute. The value of mutual fund assets we managed was \$6.0 billion as of June 30, 2001, which included \$2.3 billion derived from our variable life insurance and variable annuity products and \$28.9 million related to the retail class of shares of our Principal Investors Fund. We provide accounting, compliance, corporate governance, product development and transfer agency functions for all mutual funds we organize. As of June 30, 2001, our mutual fund operations served approximately 596,000 mutual fund shareholder accounts.

PRINCIPAL MUTUAL FUNDS. Principal Mutual Funds is a family of mutual funds offered to individuals and businesses, with 26 mutual funds as of June 30, 2001. We report the results for these funds in this segment under "Mutual Funds".

The table below shows a breakdown between our affiliated and third-party asset managers within Principal Mutual Funds, by investment type, for the periods indicated:

U.S. ASSET ACCUMULATION  
PRINCIPAL MUTUAL FUNDS BY ASSET MANAGER  
AS OF JUNE 30, 2001

INVESTMENT TYPE	AFFILIATED		THIRD-PARTY		TOTAL	
	ASSETS UNDER MANAGEMENT	NUMBER OF FUNDS	ASSETS UNDER MANAGEMENT	NUMBER OF FUNDS	ASSETS UNDER MANAGEMENT	NUMBER OF FUNDS
	(\$ IN BILLIONS)					
Equity						
Domestic U.S. ....	\$2.2	9	\$0.1	6	\$2.3	15
International.....	0.4	5	--	--	0.4	5
Income.....	0.7	5	--	--	0.7	5
Money Market.....	0.4	1	--	--	0.4	1
	----	----	----	----	----	----
Total.....	\$3.7	20	\$0.1	6	\$3.8	26
	=====	=====	=====	=====	=====	=====

The table below shows our mutual funds asset flow summary for the periods indicated:

U.S. ASSET ACCUMULATION  
PRINCIPAL MUTUAL FUNDS ASSET FLOW SUMMARY

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,	AS OF OR FOR THE YEAR ENDED DECEMBER 31,	
	2001	2000	1999
	(\$ IN BILLIONS)		
Assets Under Management, beginning of period.....	\$ 3.9	\$ 4.1	\$ 3.7
Deposits.....	0.7	1.3	1.3
Withdrawals.....	(0.6)	(1.4)	(1.1)
Investment Performance.....	(0.2)	(0.1)	0.2
Other.....	--	--	--
	----	----	----
Assets Under Management, end of period.....	\$ 3.8	\$ 3.9	\$ 4.1
	=====	=====	=====

**PRINCIPAL VARIABLE CONTRACTS FUND.** Principal Variable Contracts Fund is a series mutual fund which, as of June 30, 2001, provided 26 investment options for use as funding choices in variable annuity and variable life insurance contracts issued by Principal Life. As of June 30, 2001, this fund had \$2.3 billion in assets under management. We report the results for the funds backing variable annuity contracts in this segment under "Individual Annuities." We report the results for the funds backing variable life insurance contracts in the Life and Health Insurance segment.

**PRINCIPAL INVESTORS FUND.** Principal Investors Fund is a newly expanded series mutual fund which, as of June 30, 2001, offered 44 investment options. This fund acts as the funding vehicle for Principal Advantage, the defined contribution product described above under "-- U.S. Asset Management and Accumulation -- U.S. Asset Accumulation -- Pension -- Products and Services -- Full-service Accumulation." This fund also offers a retail class of shares to individuals and businesses. We report the results for this fund, excluding the retail class of shares, under "Pension". We report the results of the retail class of shares in this segment under "Mutual Funds." As of June 30, 2001, this retail class of shares had \$28.9 million in assets under management.

**MARKETS AND DISTRIBUTION**

Our markets for mutual funds are individuals seeking to accumulate savings for retirement and other purposes and small businesses seeking to use mutual funds as the funding vehicle for pension plans, as well as non-qualified individual savings plans utilizing payroll deductions. We also market our retail mutual funds to participants in pension plans who are departing their plans and reinvesting their retirement assets into individual retirement accounts.

Our mutual funds are sold primarily through our affiliated financial representatives, independent brokers registered with our securities broker-dealer Prncor Financial Services Corporation, or Prncor, registered representatives from other broker-dealers, direct deposits from our employees and others and Principal Connection. Prncor, as the marketing arm of our mutual fund business, recruits, trains and supervises registered representatives selling our products who numbered approximately 3,500 at June 30, 2001, including our affiliated financial representatives.

Registered representatives are responsible for understanding the customer's investment objectives and financial situation, complying with all regulations pertaining to the solicitation and/or execution of securities transactions and providing current information to the customer. Affiliated financial representatives produced 47%, or \$157.2 million, of our mutual fund sales for the six months ended June 30, 2001.

The table below shows sales, as measured by deposits, of our mutual funds by distribution channel for the periods indicated:

U.S. ASSET ACCUMULATION  
MUTUAL FUNDS SALES BY DISTRIBUTION CHANNEL(1)

	FOR THE SIX	FOR THE YEAR ENDED		
	MONTHS ENDED	DECEMBER 31,		
	JUNE 30,	2000	1999	1998
	2001			
	(\$ IN MILLIONS)			
Affiliated financial representatives.....	\$157.2	\$326.9	\$442.0	\$517.6
Principal Connection.....	99.5	141.5	114.2	104.4
Independent brokers and registered representatives of				
Princor.....	9.2	13.6	3.3	--
Other (non-affiliated) broker-dealers.....	47.4	66.9	40.4	76.5
Direct deposits(2).....	22.7	18.6	25.9	29.8
Total.....	\$336.0	\$567.5	\$625.8	\$728.3
	=====	=====	=====	=====

(1) Excludes deposits to money market funds totaling \$357.0 million for the six months ended June 30, 2001, \$732.8 million in 2000, \$621.3 million in 1999 and \$2,067.4 million in 1998.

(2) Direct deposits from the Principal Financial Group employees and others.

INDIVIDUAL ANNUITIES

Individual annuities offer a tax-deferred means of accumulating retirement savings and provide a tax-efficient source of income during the payout period.

PRODUCTS AND SERVICES

We offer both fixed and variable annuities to individuals. Individual annuities may be deferred, in which case assets accumulate until the contract is surrendered, the customer dies or the customer begins receiving benefits under an annuity payout option, or immediately, in which case payments begin within one year of issue and continue for a fixed period of time or for life.

**FIXED ANNUITIES.** Our individual fixed annuities are predominantly single premium deferred annuity contracts. These contracts are savings vehicles through which the customer makes a single deposit with us. Under the contract, the principal amount is guaranteed and for a specified time period, typically one year, we credit the customer's account at a fixed interest rate. Thereafter, we reset, typically annually, the interest rate credited to the contract based upon market and other conditions. Our major source of income from fixed annuities is the spread between the investment income we earn on the underlying general account assets and the interest rate we credit to customers' accounts. We bear the investment risk because, while we credit customers' accounts with a stated interest rate, we cannot be certain the investment income we earn on our general account assets will exceed that rate.

**VARIABLE ANNUITIES.** Our individual variable annuity products consist almost entirely of flexible premium deferred variable annuity contracts. These contracts are savings vehicles through which the customer makes a single deposit or a series of deposits of varying amounts and intervals. Customers have the flexibility to allocate their deposits to investment sub-accounts managed by Principal Capital Management, or third-party asset managers including Fidelity Investments(R), AIM Advisors, Inc., Morgan Stanley Asset Management, J.P. Morgan Investment Management, Inc., Janus Capital Corporation, Neuberger Berman Management, Inc., The Dreyfus Corporation, Goldman Sachs Asset Management, Duncan-Hurst Capital Management, Inc., Turner Investment Partners, Inc., and Berger, LLC. As of June 30, 2001, 58% of our \$2.3 billion in variable annuity account balances were allocated to investment sub-accounts managed by Principal Capital Management, 31% to investment sub-accounts managed by third-party asset managers and 11% to our general account, also managed by Principal Capital Management. The value of the annuity fluctuates in accordance with the experience of the investment sub-accounts chosen by the customer. The customers bear the investment risk and have the right to allocate their assets among various separate investment sub-accounts. Customers have the option to allocate all or a portion of their account to our general account, in which case we credit interest at rates we determine, subject to contractual minimums. Customers may also elect death benefit guarantees. Our major

source of revenue from variable annuities is mortality and expense fees we charge to the customer, generally determined as a percentage of the market value of the assets held in a separate investment sub-account.

The table below presents summary information regarding our annuity reserve activity for the periods indicated:

U.S. ASSET ACCUMULATION  
INDIVIDUAL ANNUITY ACCOUNT VALUE ACTIVITY

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,	AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
-----				
(\$ IN MILLIONS)				
<b>FIXED ANNUITIES:</b>				
Total Account Value, beginning of period.....	\$2,364.5	\$2,480.9	\$2,641.4	\$2,797.6
Premiums and deposits.....	70.3	162.0	208.9	261.3
Interest credited.....	65.6	138.6	136.2	149.7
Surrenders and benefits.....	(199.9)	(412.5)	(500.8)	(562.3)
Product charges.....	(2.0)	(4.5)	(4.8)	(4.9)
	-----	-----	-----	-----
Total Account Value, end of period.....	\$2,298.5	\$2,364.5	\$2,480.9	\$2,641.4
	=====	=====	=====	=====
Number of Contracts, end of period.....	65,703	68,179	75,119	82,481
<b>VARIABLE ANNUITIES:</b>				
Total Account Value, beginning of period.....	2,348.5	\$2,202.7	\$1,762.8	\$1,297.2
Deposits.....	234.0	444.0	385.7	420.6
Interest credited and investment performance.....	(155.4)	(75.1)	232.6	154.6
Surrenders and benefits.....	(98.3)	(193.0)	(153.1)	(91.0)
Product charges.....	(14.7)	(30.1)	(25.3)	(18.6)
	-----	-----	-----	-----
Total Account Value, end of period.....	\$2,314.1	\$2,348.5	\$2,202.7	\$1,762.8
	=====	=====	=====	=====
Number of Contracts, end of period.....	46,235	44,146	39,767	35,283
<b>TOTAL ANNUITIES:</b>				
Total Account Value, beginning of period.....	\$4,713.0	\$4,683.6	\$4,404.2	\$4,094.8
Premiums and deposits.....	304.3	606.0	594.6	681.9
Interest credited and investment performance.....	(89.7)	63.5	368.8	304.3
Surrenders and benefits.....	(298.3)	(605.5)	(653.9)	(653.3)
Product charges.....	(16.8)	(34.6)	(30.1)	(23.5)
	-----	-----	-----	-----
Total Account Value, end of period.....	\$4,612.5	\$4,713.0	\$4,683.6	\$4,404.2
	=====	=====	=====	=====
Number of Contracts, end of period.....	111,938	112,325	114,886	117,764

**MARKETS AND DISTRIBUTION**

Our target markets for individual annuities include owners, executives and employees of small and medium-sized businesses, and individuals seeking to accumulate and/or eventually distribute assets for retirement. We market both fixed and variable annuities to both qualified and non-qualified pension plans.

We sell our individual annuity products largely through our affiliated financial representatives, who accounted for 83%, 82%, 79% and 82% of annuity sales for the six months ended June 30, 2001, and the years ended December 31, 2000, 1999 and 1998, respectively. The remaining sales were made through brokerage general agencies, banks, Principal Connection and unaffiliated broker-dealer firms.

The table below shows sales of our individual annuities by distribution channel for the periods indicated:

U.S. ASSET ACCUMULATION  
INDIVIDUAL ANNUITY SALES BY DISTRIBUTION CHANNEL(1)

	FOR THE SIX MONTHS ENDED JUNE 30,	FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
	----- (\$ IN MILLIONS) -----			
Affiliated financial representatives.....	\$251.5	\$499.4	\$409.0	\$443.0
Independent brokers and registered representatives of Princor.....	18.0	35.4	38.8	49.1
Other (non-affiliated) broker dealers.....	0.8	18.3	14.9	3.1
Banks.....	24.9	30.2	32.8	33.6
Principal Connection.....	9.1	22.7	23.5	13.1
	-----			
Total.....	\$304.3	\$606.0	\$519.0	\$541.9
	=====			

-----  
(1) Excludes deposits related to rollovers from Principal draft account products.

PRINCIPAL BANK

Principal Bank, our electronic banking operation, is a federal savings bank that began its activities in February 1998. It offers traditional retail banking products and services via the telephone, Internet, ATM or by mail. Our current products and services offering includes checking and savings accounts, certificates of deposit, consumer and home equity loans, credit cards, debit cards, money market accounts and a college savings program. As of June 30, 2001, Principal Bank had 49,825 customers and \$880.6 million in assets, principally representing saving account deposits and certificates of deposit.

We market our Principal Bank products and services through Principal Connection to our existing customers, especially pension plan participants. Through Principal Bank, we also pursue asset retention strategies with our existing customers who seek to transfer assets from our other asset accumulation products by offering them our banking products and services.

PRINCIPAL CAPITAL MANAGEMENT

In 1999, we established Principal Capital Management to consolidate our extensive investment management expertise and to focus on marketing our asset management services to third-party institutional clients. Principal Capital Management provides asset management services to our U.S. asset accumulation businesses and third-party institutional clients, as well as our other U.S.-based segments. Principal Capital Management provides a full range of asset management services with a particular emphasis on three primary asset classes: (1) equity investments; (2) fixed income investments; and (3) real estate investments. Principal Capital Management manages both U.S. and international assets.

As of June 30, 2001, Principal Capital Management, through its affiliates, Invista Capital Management, Principal Capital Income Investors and Principal Capital Real Estate Investors, managed \$84.0 billion in assets. Our third-party institutional assets were \$5.8 billion as of June 30, 2001, compared to \$3.5 billion on January 1, 1999, the establishment date of Principal Capital Management.



The following table shows Principal Capital Management's assets under management by asset class for the periods indicated:

PRINCIPAL CAPITAL MANAGEMENT  
ASSETS UNDER MANAGEMENT BY ASSET CLASS

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998(1)	
	(\$ IN BILLIONS)							
U.S. Equity.....	\$ 20.2	24%	\$22.4	27%	\$25.9	32%	\$23.2	30%
International Equity.....	4.4	5	5.6	7	6.3	8	4.5	6
Fixed Income.....	36.9	44	33.7	40	28.4	34	27.2	35
Commercial Mortgages.....	14.1	17	14.1	17	14.8	18	15.0	19
Commercial Real Estate Equity.....	5.5	7	5.6	7	5.5	7	5.8	8
Other.....	2.9	3	1.8	2	1.3	1	1.4	2
Total.....	\$ 84.0	100%	\$83.2	100%	\$82.2	100%	\$77.1	100%

(1) Includes assets managed by Invista Capital Management and the former investment department of Principal Life prior to the formation of Principal Capital Management, effective January 1, 1999.

The table below shows our asset flow summary for Principal Capital Management operations for the periods indicated:

PRINCIPAL CAPITAL MANAGEMENT  
ASSET FLOW SUMMARY

	AS OF OR FOR THE	AS OF OR FOR THE	
	SIX MONTHS	YEAR ENDED	
	ENDED JUNE 30,	DECEMBER 31,	
	2001	2000	1999
	(\$ IN BILLIONS)		
Assets Under Management, beginning of period.....	\$ 83.2	\$ 82.2	\$ 77.1(1)
Deposits.....	8.8	17.4	16.3
Withdrawals.....	(7.7)	(15.9)	(12.9)
Investment Performance.....	0.3	1.1	6.7
Other.....	(0.6)	(1.6)	(5.0)
Assets Under Management, end of period.....	\$ 84.0	\$ 83.2	\$ 82.2

(1) Includes assets managed by Invista Capital Management and the former investment department of Principal Life prior to the formation of Principal Capital Management, effective January 1, 1999.

STRATEGY

We seek to provide asset management services that respond to the needs of our asset accumulation operations and third-party institutional clients. Our capabilities include expertise in equities, commercial real estate and fixed income securities. Principal Capital Management pursues the following strategic initiatives:

**GROW OUR THIRD-PARTY INSTITUTIONAL ASSETS UNDER MANAGEMENT.** We are developing relationships with customers and intermediaries through our expanded institutional marketing staff. We have increased our third-party institutional marketing and client service staff from five to more than forty over the past three years. We have also increased the number of consultant informational databases to which we provide product information. As a result, in 2000 we gained 27 new institutional mandates, up from 16 in 1999, and for the six months ended June 30, 2001, we received 7 institutional mandates. We believe these marketing efforts have led to the considerable growth in our third-party institutional assets under management since 1999. We also market the combined expertise of Principal Capital Management and BT Financial Group to third-party institutional clients through joint marketing offices in London, Hong Kong and Singapore. BT Financial Group's asset management expertise is complementary to the expertise of Principal Capital Management.

**IMPROVE OUR ASSET MANAGEMENT CAPABILITIES AND SERVICES.** During 2000, we instituted greater discipline in our investment management process to better ensure that our performance compares favorably to the appropriate

benchmark. We have also increased the number of experienced investment professionals we employ. We believe these actions will improve our ability to attract investment advisory allocations from our asset accumulation operations and from investment mandates from third-party institutions.

**INCREASE THE NUMBER OF AVAILABLE INVESTMENT STYLES AND ASSET CLASSES.** To better serve our existing clients and attract new clients, we have made additional investment styles and asset classes available to our customers. For example, we offer U.S. equities, emerging market equities, international small capitalization equities, international fixed income securities, commercial mortgage-backed securities and real estate mezzanine/bridge loans. We believe that increasing the number of asset classes we offer will help us increase our assets under management.

#### PRODUCTS AND SERVICES

Principal Capital Management provides a full range of asset management services, with a particular emphasis on three asset classes through a range of vehicles including separate accounts, mutual funds, institutional accounts, collateralized debt securities and Principal Life's general account:

**EQUITY INVESTMENTS.** Principal Capital Management, through its affiliate, Invista Capital Management, managed equity portfolios, which represented \$24.6 billion in assets as of June 30, 2001. Invista Capital Management provides our clients with access to a broad array of domestic, international and emerging markets equity capabilities. The domestic equity products are organized across growth and value styles, with portfolios targeted to distinct capitalization ranges. As of June 30, 2001, 78% of Invista Capital Management's assets under management were derived from our pension products, 16% from other products of the Principal Financial Group, and the remaining 6% from third-party institutional clients.

**FIXED INCOME INVESTMENTS.** Principal Capital Management, through its affiliate, Principal Capital Income Investors, managed \$36.9 billion in fixed income assets as of June 30, 2001. Principal Capital Income Investors provides our clients with access to investment-grade corporate debt, mortgage-backed, asset-backed and commercial mortgage-backed securities, high yield and municipal bonds and private and syndicated debt instruments. As of June 30, 2001, 70% of these assets were derived from our pension products, 28% from other products of the Principal Financial Group, and the remaining 2% from third-party institutional clients.

**REAL ESTATE INVESTMENTS.** Principal Capital Management, through its affiliate, Principal Capital Real Estate Investors, managed a commercial real estate portfolio of \$19.6 billion of assets as of June 30, 2001. Principal Capital Real Estate Investors provides our clients with a broad range of real estate investment options, including private real estate equity, commercial mortgages, credit tenant debt, construction-permanent financing, bridge/mezzanine loans, commercial mortgage-backed securities and real estate investment trusts. Principal Capital Management had \$0.8 billion of assets under management as of June 30, 2001, from bridge/mezzanine loans and commercial mortgages which appear on its balance sheet. The commercial mortgages represent the source of mortgages for our commercial mortgage-backed securitization program. As of June 30, 2001, 52% of the commercial real estate portfolio was derived from our pension products, 31% from other products of the Principal Financial Group, and the remaining 17% from third-party institutional clients.

INVESTMENT PERFORMANCE

A primary measure of asset management services is investment performance. The table below shows the number of funds and investment performance of Principal Capital Management's managed separate accounts and mutual funds, by investment type, compared to other funds by Morningstar as of June 30, 2001:

PRINCIPAL CAPITAL MANAGEMENT  
PERFORMANCE BY INVESTMENT TYPE  
AS OF JUNE 30, 2001

INVESTMENT TYPE	SEPARATE ACCOUNTS				MUTUAL FUNDS			
	NUMBER OF FUNDS(1)	ASSETS UNDER MANAGEMENT	FUNDS WITH 3 STARS OR ABOVE/FUNDS RANKED	ASSETS UNDER MANAGEMENT	NUMBER OF FUNDS	ASSETS UNDER MANAGEMENT	FUNDS WITH 3 STARS OR ABOVE ON CLASS A SHARES/FUNDS RANKED(2)	ASSETS UNDER MANAGEMENT
	(\$ IN BILLIONS)							
Equity								
Domestic U.S. ....	26	\$16.5	6/10	\$ 9.2/\$16.1	9	\$2.2	4/8	\$0.7/\$2.2
International.....	6	2.7	3/4	2.5/2.6	5	0.4	2/3	0.1/0.4
Real Estate.....	1	1.2	N/A	N/A	N/A	--	N/A	N/A
Fixed Income.....	12	5.9	4/4	5.9/5.9	5	0.7	3/5	0.5/0.7
Money Market.....	1	2.4	N/A	N/A	1	0.4	N/A	N/A
Total.....	46	\$28.7	13/18	\$17.6/\$24.6	20	\$3.7	9/16	\$1.3/\$3.3
	==	=====	=====	=====	==	====	=====	=====

(1) Includes funds that are not rated by Morningstar.

(2) According to Morningstar, a fund's ten year return accounts for 50% of its overall rating score, its five year return accounts for 30% and its three year return accounts for 20%. If only five years of history are available, the five year period is weighted 60% and the three year period is weighted 40%. According to Morningstar, funds in the top 67.5% of their asset category receive 3 stars or above.

MARKETS AND DISTRIBUTION

Principal Capital Management employed 48 institutional sales, relationship management and client service professionals as of June 30, 2001, who worked with consultants and directly with large investors to acquire and retain third-party institutional clients. For the six months ended June 30, 2001, approximately 43% of new institutional clients were originated through direct client contact by Principal Capital Management representatives with the balance derived from consultants.

We also market the combined expertise of Principal Capital Management and BT Financial Group to third-party institutional clients through joint marketing offices in London, Hong Kong and Singapore. BT Financial Group's asset management expertise is complementary to the expertise of Principal Capital Management.

The table below shows Principal Capital Management's assets under management by accumulation source for the periods indicated:

PRINCIPAL CAPITAL MANAGEMENT  
ASSETS UNDER MANAGEMENT BY ACCUMULATION SOURCE(1)

ACCUMULATION SOURCE	AS OF JUNE 30,	AS OF DECEMBER 31,		
	2001	2000	1999	1998(2)
	(\$ IN BILLIONS)			
Affiliated				
Pension				
General Account.....	\$29.7	\$28.6	\$27.8	\$27.1
Separate Account.....	27.8	28.8	30.9	27.0
Mutual Funds.....	3.7	3.8	4.0	3.7
Individual Annuities				
General Account.....	2.7	2.8	2.8	3.0
Separate Account.....	1.3	1.3	1.4	1.3
Life and Health Insurance General Account.....	9.1	9.0	8.5	8.1
Separate Account.....	0.2	0.2	0.1	0.1
Other.....	3.7	2.4	2.0	3.3
Total Affiliated.....	78.2	76.9	77.5	73.6
Third-party Institutional.....	5.8	6.3	4.7	3.5
Total.....	\$84.0	\$83.2	\$82.2	\$77.1

(1) Includes all assets for which Principal Capital Management provides investment advisory services.

(2) Includes assets managed by Invista Capital Management and the former investment department of Principal Life prior to the formation of Principal Capital Management, effective January 1, 1999.

INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION SEGMENT

Our International Asset Management and Accumulation segment consists of BT Financial Group and Principal International. As of June 30, 2001, BT Financial Group was the fifth largest asset manager in Australia according to ASSIRT. As of June 30, 2001, BT Financial Group had accumulated \$22.6 billion of assets under management and provided investment advisory services to \$21.1 billion in assets. Principal International has subsidiaries in Argentina, Chile, Mexico and Hong Kong and joint ventures in Brazil, Japan and India. We focus on countries with favorable demographics and a trend toward private sector defined contribution pension systems. We entered these countries through acquisitions and joint ventures.

Our International Asset Management and Accumulation segment generated 7%, 7%, 4% and 3% of our total operating revenues and \$(4.7) million, \$(8.5) million, \$(38.4) million and \$(35.4) million of our total operating earnings for the six months ended June 30, 2001 and the years ended December 31, 2000, 1999 and 1998, respectively.

The table below shows the operating revenues, operating earnings, assets and assets under management of our International Asset Management and Accumulation segment for the periods indicated:

INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION  
SELECTED FINANCIAL HIGHLIGHTS

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,					
	2001		2000	1999(3)	1998			
	(\$ IN MILLIONS)							
OPERATING REVENUES(1):								
BT Financial Group.....	\$ 122.4	39%	\$ 285.3	45%	\$ 113.8	30%	\$ --	--%
Principal International.....	187.7	61	345.4	55	265.8	70	223.1	100
Total.....	\$ 310.1	100%	\$ 630.7	100%	\$ 379.6	100%	\$ 223.1	100%

INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION  
SELECTED FINANCIAL HIGHLIGHTS -- (CONTINUED)

	FOR THE SIX MONTHS ENDED JUNE 30,		FOR THE YEAR ENDED DECEMBER 31,					
	2001		2000		1999(3)		1998	
			(\$ IN MILLIONS)					
OPERATING EARNINGS (LOSS):								
BT Financial Group(2).....	\$ (5.8)	N/A	\$ 6.3	N/A	\$ (4.8)	N/A	\$ --	N/A
Principal International.....	1.1	N/A	(14.8)	N/A	(33.6)	N/A	(35.4)	N/A
Total.....	\$ (4.7)	N/A	\$ (8.5)	N/A	\$ (38.4)	N/A	\$ (35.4)	N/A
ASSETS:								
BT Financial Group.....	\$3,182.7	65%	\$3,716.8	67%	\$4,472.8	75%	\$ --	--%
Principal International.....	1,736.9	35	1,809.1	33	1,454.0	25	1,239.4	100
Total.....	\$4,919.6	100%	\$5,525.9	100%	\$5,926.8	100%	\$1,239.4	100%
ASSETS UNDER MANAGEMENT:								
(\$ in billions)								
BT Financial Group.....	\$ 22.6	88%	\$ 25.4	89%	\$ 28.6	93%	\$ --	--%
Principal International.....	3.1	12	3.0	11	2.0	7	1.2	100
Total.....	\$ 25.7	100%	\$ 28.4	100%	\$ 30.6	100%	\$ 1.2	100%

(1) Excludes net realized capital gains and their impact on recognition of front-end fee revenues.

(2) Reflects amortization of goodwill and other intangibles related to the acquisition of BT Financial Group.

(3) Reflects operations of BT Financial Group from August 31, 1999, the date of its acquisition.

BT FINANCIAL GROUP

Our acquisition of BT Financial Group was a central element in our expansion of our international asset management and accumulation businesses. BT Financial Group's operations include:

- retail funds management;
- institutional asset management;
- margin lending;
- portfolio services; and
- New Zealand.

In November 1998, Deutsche Bank AG announced the purchase of Bankers Trust Corporation, the parent company of Bankers Trust Australia Group. In March 1999, Deutsche Bank announced its intention to sell Bankers Trust's Australian operations while retaining its asset management operations in Japan, the U.K. and New York. During the period that Bankers Trust's Australian operations were for sale, many investment advisors in Australia suspended new deposits pending clarification on the ownership of the business. On August 31, 1999, we purchased Bankers Trust Australia Group, including BT Funds Management and related businesses. We subsequently changed its name to BT Financial Group.

We measure assets under management in two ways, both by the operation that accumulates the assets and by the entity that manages the assets. BT Financial Group both accumulates and manages assets. From an accumulation perspective, BT Financial Group had assets under management of \$22.6 billion as of June 30, 2001. As of that same date, BT Financial Group provided investment advisory services for \$21.1 billion. The difference represents assets accumulated by BT Financial Group for which another asset manager provides investment advisory services. BT Financial Group's assets under management increased A\$1.0 billion from December 31, 1999 to June 30, 2001. However, during the same period the Australian dollar declined 22% in value relative to the U.S. dollar resulting in a \$6.0 billion decrease in assets under management in U.S. dollar terms.

The table below shows the amount of assets under management by operation for BT Financial Group for the periods indicated:

BT FINANCIAL GROUP  
ASSETS UNDER MANAGEMENT(1)

	AS OF	AS OF DECEMBER 31,		
	JUNE 30,	2000	1999	1998(2)
	2001			
	(IN BILLIONS)			
Retail.....	A\$21.6	A\$23.3	A\$20.9	A\$18.7
Institutional.....	16.9	17.5	19.7	22.0
Margin Lending.....	1.1	1.1	1.0	1.0
Portfolio Services.....	3.7	2.5	0.9	0.1
New Zealand.....	1.2	1.1	1.0	1.2
Other.....	--	0.2	--	--
Total.....	A\$44.5	A\$45.7	A\$43.5	A\$43.0
Total.....	\$22.6	\$25.4	\$28.6	\$26.4

(1) A\$ denotes Australian dollars.

(2) Includes assets managed by BT Financial Group prior to its acquisition by the Principal Financial Group. Assets are presented for comparative purposes only and are not included in segment or consolidated assets under management amounts reported elsewhere in this document.

The table below shows BT Financial Group's asset flow summary for the periods indicated:

BT FINANCIAL GROUP  
ASSET FLOW SUMMARY(1)

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,			
	2001	2000	1999(2)			
	(IN BILLIONS)					
Assets Under Management, beginning of period.....	A\$45.7	\$25.4	A\$43.5	\$28.6	A\$43.0	\$26.4
Net Deposits and Withdrawals.....	(0.3)	(0.1)	1.3	0.7	(4.0)	(2.7)
Investment Performance.....	(0.5)	(0.2)	0.9	0.5	4.5	3.0
Effect of Exchange Rates.....	--	(2.3)	--	(4.4)	--	1.9
Other.....	(0.4)	(0.2)	--	--	--	--
Assets Under Management, end of period.....	A\$44.5	\$22.6	A\$45.7	\$25.4	A\$43.5	\$28.6

(1) A\$ denotes Australian dollars.

(2) Includes assets managed by BT Financial Group prior to its acquisition by the Principal Financial Group. Assets are presented for comparative purposes only and are not included in segment or consolidated assets under management amounts reported elsewhere in this document.

STRATEGY

Our strategic initiatives for BT Financial Group include:

**FURTHER INTEGRATE BT FINANCIAL GROUP'S ACTIVITIES.** We continue to look for opportunities to capture synergies between BT Financial Group and our operating segments, especially with respect to product distribution and operating platforms. For example, we offer BT Financial Group-managed products in our U.S. 401(k) products. Similarly, we offer Principal Capital Management-managed products to institutions in Australia through BT Financial Group's existing distribution network.

**GROW OUR RETAIL FUNDS MANAGEMENT BUSINESS WITH EMPHASIS ON CORPORATE MASTER TRUST SUPERANNUATION PLANS.** We believe that BT Financial Group has a strong financial sector brand in Australia, in addition to an extensive family of

investment products. It also has distribution relationships with most major Australian banks, life insurers, independent financial advisors and other distributors of financial products.

The Australian asset management market has grown in part from the introduction of superannuation, a mandatory, tax-favored defined contribution retirement system established in the early 1990s. According to a March 2000 report by Cerulli Associates, Inc., from June 1995 to June 1999, Australian superannuation assets grew from A\$228.0 billion to A\$408.0 billion, a compound annual growth rate of 15.7%. Under superannuation, all employers in Australia are required to contribute 8%, increasing to 9% in July 2002, of an employee's salary to a defined contribution pension plan. These mandatory contributions will provide continued growth in assets under management in Australia generally and, we believe, will provide the opportunity for attractive growth for BT Financial Group specifically.

Utilizing its brand recognition and extensive distribution channels, BT Financial Group has increased its marketing efforts on the sale of corporate master trust superannuation plans, especially those of small and medium-sized businesses. These corporate master trust plans are similar to 401(k) plans in the United States in that they are employer-sponsored defined contribution plans. We believe that BT Financial Group's strong market position, together with the expertise we have developed in the U.S. defined contribution pension market, should provide for long-term growth in our assets under management in Australia.

**GROW OUR THIRD-PARTY INSTITUTIONAL ASSET MANAGEMENT BUSINESS OUTSIDE OF AUSTRALIA.** BT Financial Group and Principal Capital Management together target markets abroad through joint marketing offices in London, Hong Kong and Singapore. These offices market the institutional investment advisory services of both operations. BT Financial Group also provides investment advisory services to Principal International.

**GROW BT FINANCIAL GROUP'S WRAP PRODUCT.** BT Financial Group's Wrap product is an Internet-based portfolio transaction and administration service targeted at independent financial advisors. It enables a financial planner to track a client's total portfolio and provide consolidated reporting and transaction capabilities in a user-friendly and cost effective manner. Since its launch in early 1998, Wrap assets under management have grown from \$0.5 billion (A\$0.9 billion) as of December 31, 1999 to \$1.8 billion (A\$3.6 billion) as of June 30, 2001. We believe that we have a competitive lead in the provision of this type of administration service to financial advisors and their clients in Australia.

#### PRODUCTS AND SERVICES

BT Financial Group offers a wide range of investment products, margin lending and portfolio services.

**RETAIL FUNDS MANAGEMENT.** To its retail clients, BT Financial Group offers an extensive range of retirement and investment services, including retail mutual funds, pensions, annuities and corporate superannuation plans to over 500,000 retail customers as of June 30, 2001. BT Financial Group makes available a client service call center and the "BT Online" Internet site, both providing account information and transaction services for investors and financial intermediaries.

**INSTITUTIONAL ASSET MANAGEMENT.** To its larger institutional clients, both in Australia and in targeted global markets, BT Financial Group offers products and services covering a full investment range, including actively managed diversified and specialist funds, individual client mandates, pooled investment funds, global equities and fixed income securities, as well as currency and asset allocation overlays. An overlay is a portfolio strategy that allows an institution to seek enhanced portfolio returns by changing its exposure to asset classes without liquidating a portion of its portfolio.

**MARGIN LENDING.** BT Financial Group is one of the largest margin lenders in the Australian market. According to Cannex's May 2001 margin lending report, BT Financial Group was awarded a five star rating (out of 5) on three of its margin lending products and a four star rating on four other margin lending products. Margin lending products assigned five stars are described by Cannex as "Excellent" while those assigned four stars are characterized as "Very Good." Margin lending enables investors to borrow up to 70% of the value of mutual funds and select listed securities. Rising levels of share ownership among Australian investors has generated increased margin lending, with BT Financial Group's margin lending portfolio balance of \$0.6 billion (A\$1.1 billion) as of June 30, 2001. On November 30, 1999, BT Financial Group margin lending operations securitized its margin lending portfolio with Westpac Banking Corporation, an Australian Bank. Under the terms of the financing, BT Financial Group margin lending operations are required to allocate capital equal to approximately 7% of the outstanding borrowed amount, as a cushion for loan defaults.

**PORTFOLIO SERVICES.** BT Financial Group is a leading provider of investment administration and processing in Australia and New Zealand. Wrap is our fastest growing portfolio services product. It provides independent financial advisors with a range of investment choices for their clients administered via a central Internet-based source with a choice of mutual funds and listed equity securities. This product enables them, on behalf of their clients, to manage all of a client's investment portfolio. Wrap also provides for custody, settlement and accounting of all investments with online account capabilities and reporting to the investor.

NEW ZEALAND. BT New Zealand provides a comprehensive range of retail and institutional asset management services in New Zealand. BT Financial Group's New Zealand business had \$0.6 billion (A\$1.2 billion) of assets under management as of June 30, 2001.

#### INVESTMENT PERFORMANCE

As of June 30, 2001, BT Financial Group had a staff of 96 investment professionals actively managing mutual funds, superannuation plans and other related investment products. Within the funds management operations, it has developed particular expertise managing equity and fixed income funds, both in Australia and internationally.

Since October 2000, our Australian equity investment performance has been disappointing. We have recently taken actions to improve performance, including:

- appointment of new senior management in asset management including chief investment officer and senior equities positions; and
- enhancement of the equity portfolio management process aimed at reducing the volatility of investment returns by implementing tighter risk controls.

The table below shows investment performance of BT Financial Group's retail mutual funds, superannuation plans and other retirement related products compared to other funds by Morningstar:

BT FINANCIAL GROUP  
PERFORMANCE BY INVESTMENT TYPE  
AS OF JUNE 30, 2001

INVESTMENT TYPE	NUMBER OF FUNDS	ASSETS UNDER MANAGEMENT (A\$ IN BILLIONS)	FUNDS WITH MORNINGSTAR RATINGS IN THE TOP 2 QUANTILES/FUNDS RATED(1)	
			NUMBER OF FUNDS	ASSETS UNDER MANAGEMENT(2) (A\$ IN BILLIONS)
Equity:				
Australian.....	20	A\$2.3	--/10	A\$--/A\$1.9
International.....	40	7.3	10/11	5.3/5.3
Income.....	18	0.3	10/13	0.1/0.3
Balanced.....	41	10.3	4/23	2.8/9.3
Money Market.....	8	0.9	2/6	0.2/0.8
Other.....	50	0.5	--/--	--/--
Total.....	177	A\$21.6	26/63	A\$8.4/A\$17.6
	===	=====	=====	=====

(1) Morningstar rates the performance of our funds by comparing the total return of each fund to the total return of mutual funds in the same asset category as the separate account. Morningstar ranks total returns on a scale of 1-100, where 1 represents the highest-returning 1% of all funds in that asset category and 100 represents the lowest-returning 1% of all funds. For example, a quartile rank of 1 for the trailing five-year period would indicate that the fund's five-year total return places it in the top 25% of all funds in its asset category and a quartile rank of 2 would indicate that the fund's five year total return places it in the top 50% in its asset category.

(2) Includes assets that are not rated by Morningstar.

#### MARKETS AND DISTRIBUTION

BT Financial Group's products and services are primarily sold throughout Australia and New Zealand in both the institutional and retail markets. BT Financial Group also operates institutional asset management offices in Hong Kong, Singapore and London, as well as a joint venture operation in Malaysia.

As part of its marketing strategy, BT Financial Group has a comprehensive brand and advertising strategy covering television, print media and the Internet. Building on its successful brand campaign which positions BT Financial Group in investment and superannuation, it is now also positioning itself as a leading provider in the corporate superannuation market. For example, BT Financial Group developed a television and print campaign to target employers. It focuses on employee benefits from BT Financial Group's corporate superannuation plan, referring to corporate sponsored retirement plans. BT Financial Group has experienced growth in sales of its corporate superannuation plans since the beginning of 1999. For the six months ended June 30, 2001, BT Financial Group had 193 new plans compared to 488 new plans in 2000 and 154 in 1999.



RETAIL FUNDS MANAGEMENT. The retail funds management operations of BT Financial Group provide a number of mutual funds and retirement services, including superannuation for individuals, small and medium-sized businesses and institutions, as well as pensions and annuities for retirees. These products are primarily designed to meet the needs created by the superannuation market in Australia. BT Financial Group has five investor centers in Australia, which serve existing clients and advisors and promote BT Financial Group products and services. Independent financial advisors are the main distribution channel for retail investment products and superannuation products in Australia. BT Financial Group also distributes these products through major banks, life insurers and other mutual fund managers.

INSTITUTIONAL ASSET MANAGEMENT. BT Financial Group's institutional products and services are designed for trustees of corporate superannuation funds institutions, large corporations and quasi-governmental entities. BT Financial Group distributes the majority of its institutional asset management products and services through consultants such as Towers Perrin, Mercer, Watson Wyatt, Frank Russell and others.

MARGIN LENDING. BT Financial Group's margin lending services target retail clients and independent financial advisors. These services are marketed through independent financial advisors and retail investor centers in addition to other brokers. BT Financial Group's margin lending services allow independent financial advisors to provide their clients a full range of financial services.

PORTFOLIO SERVICES. BT Financial Group provides portfolio services to large institutions, corporations and mutual fund managers. Wrap is marketed to independent financial advisors and other financial intermediaries for a fee.

NEW ZEALAND. BT Financial Group's New Zealand operations provide a comprehensive group of products and services across both the retail and institutional markets. Retail products are distributed through independent financial advisors while institutional products are distributed through consultants.

PRINCIPAL INTERNATIONAL

The activities of Principal International reflect our efforts to accelerate the growth of our assets under management by capitalizing on the international trend toward private sector defined contribution pension systems. Through Principal International, we offer retirement products and services, annuities, mutual funds and life insurance. We operate through subsidiaries in Argentina, Chile, Mexico and Hong Kong and joint ventures in Brazil, Japan and India.

The table below shows by country the amount on which we earned a fee as compared to assets on which we earned a spread for the periods indicated:

PRINCIPAL INTERNATIONAL  
ASSETS UNDER MANAGEMENT  
FEE-BASED/SPREAD-BASED COMPOSITION

	AS OF JUNE 30,			AS OF DECEMBER 31,								
	2001			2000			1999			1998		
	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL	FEE	SPREAD	TOTAL
	(\$ IN BILLIONS)											
Brazil.....	\$ --	\$0.9	\$0.9	\$ --	\$0.8	\$0.8	\$ --	\$0.6	\$0.6	\$ --	\$ --	\$ --
Chile.....	--	0.9	0.9	0.1	0.9	1.0	0.1	0.8	0.9	--	0.7	0.7
Mexico.....	0.5	0.1	0.6	0.4	--	0.4	0.2	--	0.2	0.1	--	0.1
Other countries.....	0.7	--	0.7	0.5	0.3	0.8	0.2	0.1	0.3	0.2	0.2	0.4
Total.....	\$1.2	\$1.9	\$3.1	\$1.0	\$2.0	\$3.0	\$0.5	\$1.5	\$2.0	\$0.3	\$0.9	\$1.2

The table below shows the asset flow summary for Principal International for the periods indicated:

PRINCIPAL INTERNATIONAL  
ASSET FLOW SUMMARY

	AS OF OR FOR THE	AS OF OR FOR THE	
	SIX MONTHS ENDED	YEAR ENDED	
	JUNE 30,	DECEMBER 31,	
	2001	2000	1999
	(\$ IN BILLIONS)		
Assets Under Management, beginning of period.....	\$ 3.0	\$ 2.0	\$ 1.2
Deposits.....	0.9	1.2	0.4
Withdrawals.....	(0.5)	(0.5)	(0.1)
Investment performance.....	0.2	0.2	0.1
Operations acquired.....	--	0.2	0.6
Other.....	(0.3)	0.1	(0.1)
Effect of exchange rates.....	(0.2)	(0.2)	(0.1)
Assets Under Management, end of period.....	\$ 3.1	\$ 3.0	\$ 2.0
	=====	=====	=====

STRATEGY

Our goal is to leverage our U.S. product expertise and operating platform to provide retirement and asset accumulation products and services in targeted international markets. We focus on countries that we believe offer the greatest long-term growth opportunities, favorable demographics and private defined contribution systems, particularly those in which small and medium-sized businesses sponsor the retirement plan. Our primary strategic initiative is to:

INCREASE THE GROWTH AND PROFITABILITY OF PRINCIPAL INTERNATIONAL

- Focus our operations on attractive markets. We have exited under-performing operations that lacked scale, such as our pre-retirement accumulation business in Argentina, and sold our operations in Spain in 2001. We remain focused on countries that have attractive long-term potential, such as Brazil, Mexico, India and Japan. We believe this focus will lead to more rapid growth in our assets under management.
- Leverage our domestic expertise in these markets. We operate under a structure in which the U.S. business unit responsible for the equivalent U.S. product is actively involved in the planning and execution of each country's business plan for such product. For example, our U.S. mutual fund management team is actively involved in overseeing our mutual fund joint venture in India. We believe that this involvement is critical to help our local country managers grow these operations.
- Leverage technology developed for U.S. operations into other countries. We utilize a common client/server-based system in most countries. This system incorporates expertise from our U.S. operations into a version scaled to each of our international operations. This common platform allows us to spread our technology expenditures throughout our operations rather than incurring greater expense by operating a separate system in each country.
- Grow revenues and manage expenses. Our operating revenues for this segment increased from \$223.1 million in 1998 to \$345.4 million in 2000, while operating expenses as a percentage of operating revenues declined from 45.4% in 1998 to 30.1% in 2000. For the six months ended June 30, 2001, operating expenses as a percentage of revenues were 25.7%.

PRODUCTS AND SERVICES

Through Principal International, we offer retirement products and services, annuities, mutual funds and life insurance.

MARKETS AND DISTRIBUTION

ASIA/PACIFIC REGION

HONG KONG. Our subsidiary in Hong Kong is actively competing in the defined contribution plan market. The government requires employers and employees each to contribute 5% of an employee's income to a Mandatory Provident Fund. We target small and medium-sized employers and distribute products through strategic alliances with insurance companies, mutual funds or banks, direct marketing and through our own sales representatives. Our strategic partners help distribute our Mandatory Provident Fund products and services, or use our administrative and investment services in their own products. Our Mandatory Provident Fund products and services are marketed by agents under the various distribution arrangements we have with our strategic partners.

INDIA. We own 50% of IDBI-Principal Asset Management Company, Ltd., or IDBI-Principal, a mutual fund company. Our joint venture partner is the Industrial Development Bank of India, or IDBI, a premier development bank in India. In addition to the current mutual fund business, we are positioning IDBI-Principal to compete in the emerging pension and long-term savings market in India. We sell our mutual funds through regional offices located throughout India and IDBI's banking offices.

JAPAN. We own 50% of ING/Principal Pensions Company, Ltd., which will sell a new defined contribution plan, as a result of legislation adopted in June 2001. This company will target small and medium-sized businesses and offer full-service record-keeping and plan administration. Our joint venture partner is ING Insurance International B.V., a member of the ING Group. Our pension sales representatives distribute our products through ING Life's independent agents to existing ING Life business clients and also through additional third-party distribution relationships developed by ING/ Principal Pensions Company, Ltd.

#### LATIN AMERICA

ARGENTINA. We own a life insurance company and a retirement annuity company. Principal Life Compania de Seguros, S.A., our life insurance company, targets small and medium-sized employers. We sell group and individual life insurance products through independent brokers and through bank branches of Societe Generale, with which we have an alliance. Societe Generale is a leading French banking institution with offices throughout Argentina through which we distribute our products. Principal Retiro Compania de Seguros de Retiro, S.A., our annuity company, provides annuities to individuals exiting the compulsory private pre-retirement asset accumulation system. We distribute annuity products through dedicated sales representatives who sell directly to customers and through independent brokers in Argentina.

BRAZIL. We own 46% of BrasilPrev, a private pension company in Brazil, through a joint venture arrangement with Banco do Brasil, Brazil's largest bank. We are Banco do Brasil's exclusive partner for distributing pension products. BrasilPrev provides defined contribution products for the retirement needs of employers and individuals. Banco do Brasil's employees sell directly to individual clients through its bank branches. BrasilPrev reaches corporate clients through two wholesale distribution channels: (1) a wholesale distribution channel distributes products through a network of independent brokers who sell to the public, and (2) another channel coordinates with Banco do Brasil's corporate account executives to reach Banco do Brasil's existing corporate clients.

CHILE. We own Principal Compania de Seguros de Vida Chile S.A., a Chilean insurance company, that primarily sells retirement annuities to individuals exiting the pre-retirement accumulation system. In July 1998, we acquired Compania de Seguros de Vida El Roble, S.A., or El Roble, a Chilean life insurance company. We have fully integrated the operations of El Roble with those of Principal Compania de Seguros de Vida Chile S.A. We distribute our annuity products through a network that consisted of over 60 captive agents and approximately 300 independent agents as of June 30, 2001. We also utilize sales representatives who sell through brokers. We also market life and health insurance products to small and medium-sized businesses and to individuals through brokers. Based upon assets, we were ranked as the fourth largest life insurance company in Chile as of June 30, 2001, according to the Superintendencia de Valores y Seguros, the Chilean regulatory agency for insurance companies. We also own 60% of Andueza & Principal Creditos Hipotecarios S.A., in a joint partnership arrangement with Andueza y Compania Agentes de Mutuos Hipotecarios S.A. Through this business, we sell and service mortgage loans in Chile.

MEXICO. We own Principal Mexico Compania de Seguros S.A. de C.V., or Principal Seguros, a life insurance company, Principal Afore S.A. de C.V., a private pension company which manages and administers individual retirement accounts under the mandatory privatized social security system in effect for all employees in Mexico and Principal Pensiones S.A. de C.V., or Principal Pensiones, an annuity company. Our focus is on both pre-retirement and post-retirement savings plans. We distributed Principal Afore S.A. de C.V.'s products and services through a dedicated sales force of approximately 550 sales representatives as of June 30, 2001, who sold directly to individuals. As of June 30, 2001, Principal Pensiones used 105 employed sales representatives and independent brokers to distribute annuities directly to customers. Our life insurance company, Principal Seguros, distributes its products through an array of independent agents and brokers.

LIFE AND HEALTH INSURANCE SEGMENT

Our Life and Health Insurance segment offers (1) individual life and disability insurance and (2) group life and health insurance throughout the United States.

Our Life and Health Insurance segment contributed 44%, 47%, 48% and 50% of our total operating revenues and 25%, 26%, 19% and 19% of our total operating earnings for the six months ended June 30, 2001 and for the years ended December 31, 2000, 1999 and 1998, respectively. The table below shows the total operating revenues, operating earnings and assets of our Life and Health Insurance segment, by individual life and disability insurance, and group life and health insurance, respectively, for the periods indicated:

LIFE AND HEALTH INSURANCE  
SELECTED FINANCIAL HIGHLIGHTS

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,					
	2001		2000		1999		1998	
	(\$ IN MILLIONS)							
<b>OPERATING REVENUES(1):</b>								
Individual Life and Disability Insurance.....	\$ 755.7	38%	\$ 1,472.9	36%	\$ 1,409.8	35%	\$1,386.0	36%
Group Life and Health Insurance.....	1,222.5	62	2,649.7	64	2,575.7	65	2,507.1	64
Total.....	\$ 1,978.2	100%	\$ 4,122.6	100%	\$ 3,985.5	100%	\$3,893.1	100%
<b>OPERATING EARNINGS:</b>								
Individual Life and Disability Insurance.....	\$ 52.7	58%	\$ 54.9	34%	\$ 86.8	96%	\$ 52.2	104%
Group Life and Health Insurance.....	38.2	42	107.4	66	3.9	4	(2.2)	(4)
Total.....	\$ 90.9	100%	\$ 162.3	100%	\$ 90.7	100%	\$ 50.0	100%
<b>ASSETS:</b>								
Individual Life and Disability Insurance.....	\$ 8,845.7	83%	\$ 8,682.1	82%	\$ 8,086.1	80%	\$7,605.1	82%
Group Life and Health Insurance.....	1,791.5	17	1,886.9	18	1,984.7	20	1,614.4	18
Total.....	\$10,637.2	100%	\$10,569.0	100%	\$10,070.8	100%	\$9,219.5	100%

(1) Excludes net realized capital gains and their impact on recognition of front-end fee revenues.

INDIVIDUAL LIFE AND DISABILITY INSURANCE

We began as an individual life insurer in 1879, and our U.S. operations served approximately 750,000 individual policyholders with \$81.8 billion of life insurance in force as of June 30, 2001. Individual life and disability insurance contributed 17%, 17%, 17% and 18% of our consolidated operating revenues for the six months ended June 30, 2001 and for the years ended December 31, 2000, 1999 and 1998, respectively.

We offer a wide array of individual life and disability insurance products aimed at serving our customers' financial needs throughout their lives.

The table below shows selected GAAP financial information regarding our individual insurance products for the periods indicated:

INDIVIDUAL LIFE AND DISABILITY INSURANCE  
SELECTED PRODUCT HIGHLIGHTS

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,	AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
	-----			
	(\$ IN MILLIONS)			
<b>INTEREST-SENSITIVE LIFE INSURANCE:</b>				
Number of policies.....	92,728	90,682	80,459	71,229
First-year premiums/Deposits.....	\$ 29.6	\$ 65.0	\$ 47.9	\$ 37.8
Premiums/Deposits.....	138.2	374.2	178.6	175.5
Future policy benefits/Policy account balance.....	1,648.7	1,567.6	1,237.2	1,070.8
Life insurance in force.....	20,898.8	19,566.8	15,633.2	12,726.6
<b>TRADITIONAL LIFE INSURANCE:</b>				
Number of policies.....	597,604	609,326	632,551	659,288
First-year premiums/Deposits.....	\$ 12.4	\$ 27.0	\$ 32.2	\$ 45.9
Premiums/Deposits.....	387.2	772.8	780.8	796.2
Future policy benefits/Policy account balance.....	5,597.7	5,522.7	5,331.6	5,119.6
Life insurance in force.....	60,940.6	60,389.0	59,581.1	59,415.9
<b>DISABILITY INSURANCE:</b>				
Number of policies.....	68,020	65,497	65,781	55,773
New sales (annualized first-year premium).....	\$ 8.2	\$ 17.2	\$ 15.1	\$ 12.7
Premiums/Deposits.....	40.6	73.9	64.5	55.6
Future policy benefits/Policy account balance.....	354.1	338.9	262.6	234.4

**STRATEGY**

We seek to provide individual life and disability insurance products tailored to the needs of the owners and executives of small and medium-sized businesses, as well as other individuals. These products also complement the asset accumulation and group insurance products that we offer to businesses. Our strategic initiatives are to:

**PROVIDE A TAILORED APPROACH TO BUSINESS NEEDS THAT CAN BE MET WITH LIFE INSURANCE.** We create marketing materials, customized policy illustrations and ongoing reports for our customers and agent/brokers that show how our insurance policies can meet the needs of the customer. For example, when highly paid individuals, such as owners of small and medium-sized businesses, use variable life insurance to fund an "excess" 401(k)-like program, they receive reports similar to those they received from their actual 401(k) plans. We believe that the ability to provide more than a basic life insurance policy illustration is critical to success in this market. We also market retirement products and services to businesses for their executives. We believe there is significant opportunity to sell products and services providing retirement and other benefits to executives in addition to pension plans. We have specialized sales representatives to sell these products to businesses.

**DESIGN OUR INDIVIDUAL DISABILITY PRODUCTS TO TARGET SMALL AND MEDIUM-SIZED BUSINESSES.** We offer products to pay business overhead expenses for a disabled business owner and for the purchase by the other business owners of the disabled business owner's interests in the business. We also offer specialized multi-life underwriting programs that facilitate the provision of coverage to multiple executives in a single business.

**INCREASE OUR DISTRIBUTION REACH TO SMALL AND MEDIUM-SIZED BUSINESSES.** In 2000, we acquired a minority stake in Highland Capital Holding Corporation, a distribution company specializing in sales of insurance to businesses and high net worth individuals. Our products will be among those marketed by Highland Capital. In 2001, we acquired Executive Benefit Services, Inc., a company that specializes in the sale of executive benefit products and services to businesses. Through Executive Benefit Services, Inc., we have begun marketing our executive benefit products and services to our existing pension customers. We constantly seek to hire individuals experienced in selling insurance to small and medium-sized businesses.

**PRODUCTS AND SERVICES**

Our individual life and disability insurance products include:

- interest-sensitive life insurance, including universal life and variable universal life;
- traditional life insurance; and
- disability insurance.

**INTEREST-SENSITIVE LIFE INSURANCE.** Interest-sensitive life products include universal life and variable universal life insurance and offer life insurance protection for which both the premium and the death benefit may be adjusted by the policyholder. Our growth in individual life and disability insurance sales through June 30, 2001, has come mainly from variable universal life insurance products, which have grown at a compound annual growth rate of 39% from 1997 to June 30, 2001. Variable universal life insurance products represented 61% of our interest-sensitive life insurance premiums for the six months ended June 30, 2001. We credit premiums, net of specified expenses, to an account maintained for the policyholder. Specific charges are made against the account for the cost of insurance protection and expenses. For universal life contracts, the entire account balance is invested in our general account. Interest is credited to the policyholder's account based on the earnings on general account investments. For variable universal life contracts, the policyholder may allocate the account balance among our general account and a variety of separate account choices. Interest is credited on amounts allocated to the general account in the same manner as for universal life. Net investment performance on separate account investments is allocated directly to the policyholder accounts. The policyholder bears the investment risk on separate account investments. Our profitability is based on charging sufficient asset-based, premium-based and risk-based fees to cover the cost of insurance and expenses.

We believe that interest-sensitive life insurance products best meet the financial objectives of our target customers in the United States because they provide flexibility, protection and cash value accumulation. In particular, sales of life insurance in non-qualified executive benefit plans are primarily variable universal life products. Our variable universal life insurance products offer asset managers low policy charges and a range of features allowing them to tailor the policy to the needs of each client.

**TRADITIONAL LIFE INSURANCE.** Traditional life insurance includes participating whole life, adjustable life products and term life insurance products. Participating products and term life insurance products represented 13% and 4%, respectively, of our individual life and disability insurance sales for the six months ended June 30, 2001. Adjustable life insurance products provide a guaranteed benefit in return for the payment of a fixed premium and allow the policyholder to change the premium and face amount combination. Participating policyholders may receive policy dividends if the combined result of interest earnings, mortality experience and expenses is better than the assumptions used in setting the premium. Our profitability is based on keeping a portion of the favorable experience before crediting the remainder to policyholders. Term insurance products provide a guaranteed benefit for a specified period of time in return for the payment of a fixed premium. Policy dividends are not paid on term insurance. Our profitability is based on charging a premium that is sufficient to cover the cost of insurance and expenses while providing us with an appropriate return.

**DISABILITY INSURANCE.** Individual disability insurance products provide a benefit in the event of the disability of the insured. In most instances, this benefit is in the form of a monthly income. Disability insurance products represented 9% of our individual life and disability insurance sales for the six months ended June 30, 2001. In addition to income replacement, we offer products to pay business overhead expenses for a disabled business owner, and for the purchase by the other business owners of the disabled business owner's interests in the business. Our profitability is based on charging a premium that is sufficient to cover claims and expenses while providing us with an appropriate return.

#### MARKETS AND DISTRIBUTION

We sell our individual products in all 50 states and the District of Columbia. Our target market is owners and executives of small and medium-sized businesses, as well as other individuals. Cash value life insurance provides valuable benefits at death and funding for needs prior to death, including funding employee benefit liabilities, estate planning, business continuation or buy-out. We design, market and administer our products to meet these needs. We have also recently established a number of marketing and distribution alliances to increase the sales of individual insurance products with firms such as AXA, Wells Fargo, Piper Jaffrey, and BISYS. Variable universal life insurance is popular for many reasons, including higher historical performance of equity investments resulting in a lower cost of insurance and an increase in values available while still alive. We also offer products specifically designed to meet the estate planning needs of business executives. Our individual disability products are also tailored to the needs of this market. Small and medium-sized businesses, their owners and executives represented 66% of individual life insurance sales and 51% of individual disability sales for the six months ended June 30, 2001, based on first-year annualized premium.

We distribute our individual insurance products primarily through our affiliated financial representatives and secondarily through independent brokers. Affiliated financial representatives were responsible for 73% of individual life insurance sales, based on first-year annualized premium for the six months ended June 30, 2001. We had 1,047 affiliated financial representatives in 49 offices as of June 30, 2001. Although they are independent contractors, we have a close tie with affiliated financial representatives and offer them benefits, training and access to tools and expertise. Independent brokers represented a larger percentage of individual disability sales with 52% of first-year annualized premium for the six months ended June 30, 2001.

GROUP LIFE AND HEALTH INSURANCE

We began offering group insurance in 1941. We served approximately 80,000 employers and provided products and services to 5.0 million covered members as of June 30, 2001. We were the 11th largest writer of group insurance in the United States based on combined group life and health premium for 1999, according to the 1999 National Underwriter Life and Health Statistical Report. We offer a broad array of group insurance products including medical, life, disability, dental and vision insurance. In addition, we also offer administrative services on a fee-for-service basis to large employers in the United States.

The tables below show the premium and premium equivalents, reserves and the incurred loss ratios for our group insurance products sold in the United States for the periods indicated:

GROUP LIFE AND HEALTH INSURANCE  
PREMIUM AND PREMIUM EQUIVALENTS

	FOR THE SIX MONTHS ENDED JUNE 30,	FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
		----- (\$ IN MILLIONS)		
Life Insurance(1).....	\$ 112.6	\$ 277.7	\$ 273.6	\$ 350.8
Disability Insurance.....	49.3	94.5	86.8	83.3
Medical Insurance(2).....	807.2	1,815.6	1,876.7	1,817.3
Dental and Vision Insurance.....	178.0	340.4	270.0	216.6
Fee-for-service.....	877.3	1,502.2	1,287.6	1,083.8
	-----	-----	-----	-----
Total.....	\$2,024.4	\$4,030.4	\$3,794.7	\$3,551.8
	=====	=====	=====	=====

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- (1) Includes \$58.6 million of premium in 1998 related to our decision to terminate two large government reinsurance pools.
- (2) Includes \$98.4 million, \$164.6 million and \$121.2 million of Medicare supplement insurance, for the years ended December 31, 2000, 1999 and 1998, respectively, all of which we reinsured effective July 1, 2000.

GROUP LIFE AND HEALTH INSURANCE  
RESERVES AND INCURRED LOSS RATIOS

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,	AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
		----- (\$ IN MILLIONS)		
RESERVES:				
Life Insurance.....	\$254.0	\$259.5	\$262.2	\$256.3
Disability Insurance.....	276.0	269.0	259.5	254.0
Medical and Medicare Supplement Insurance(1).....	315.8	316.5	396.7	300.3
Dental and Vision Insurance.....	26.0	28.2	23.8	20.6
	-----	-----	-----	-----
Total Reserves.....	\$871.8	\$873.2	\$942.2	\$831.2
	=====	=====	=====	=====
INCURRED LOSS RATIOS:				
Life Insurance.....	69%	70%	71%	79%
Disability Insurance.....	86	85	80	102
Medical and Medicare Supplement Insurance.....	82	83	90	85
Dental and Vision Insurance.....	77	76	77	77

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- (1) Includes \$47.9 million, \$46.7 million, \$68.2 million and \$40.6 million of Medicare supplement insurance, for the six months ended June 30, 2001, and the years ended December 31, 2000, 1999 and 1998, respectively, all of which we reinsured effective July 1, 2000.

#### STRATEGY

Our goal is to provide a broad range of employee benefit products and services, particularly to small and medium-sized businesses. These products and services complement those of our other businesses. Our strategic initiatives in our group life and health insurance business are:

##### IMPROVE THE PROFITABILITY OF OUR GROUP MEDICAL BUSINESS

- Emphasize sale of medical insurance to groups of 51 to 500 employees. Our ability to adjust pricing based on our underwriting standards for these groups is subject to less regulation than for the more regulated 50 employee and under market, which comprised 77% of our medical premium for the six months ended June 30, 2001.
- Exit areas of the group medical business with unsatisfactory returns. We believe the following changes helped us improve the profitability of our group insurance business:
  - We exited the "single life" group medical business for individuals under age 65 during 1997 and 1998 to focus on small and medium-sized businesses, where we believe we are well-positioned for success.
  - In 1998, after determining that the HMO business did not meet our targeted financial returns on capital deployed, we terminated our active participation within that business.
  - In 1998 and 1999, we exited the group medical insurance business in fourteen states where this business did not achieve our financial objectives.
  - In January 2000, we ceased new sales, and in July 2000, we fully reinsured our Medicare supplement business due to poor financial results and an increasingly difficult regulatory environment, in order to focus on small and medium-sized businesses.
- Strengthen pricing discipline. For the year ended December 31, 2000, we have increased average premiums by 33% on renewals. These price increases contributed to an improvement in our medical loss ratio from 90% in 1999 to 82% for the six months ended June 30, 2001, for our ongoing medical business.
- Increase efficiency and decrease unit costs. Through the use of technology, we have achieved strong gains in productivity. We plan to deliver during 2001 an Internet-based service platform to handle employer/employee changes, electronic bill presentment and payment, communication of claim information and on-line contracts and employee booklets. We expect this service platform to ultimately lower our unit costs and make it easier to do business with us.

##### GROW OUR NON-MEDICAL PRODUCTS (LIFE, DISABILITY, DENTAL AND VISION)

- Dedicate more sales efforts to non-medical products. As of June 30, 2001, we dedicated 28 non-medical sales representatives, wholesalers, to increase our focus on sales of our group, life, disability, dental and vision products. We are also expanding distribution through affiliated marketing arrangements such as general agents, non-proprietary alliances and Internet-based sales channels.
- Emphasize the sale of non-medical products separately from the sale of our medical products. Approximately 54% of our non-medical in-force contracts as of December 31, 1999 were not tied to a medical contract, whereas approximately 65% of our new non-medical sales for the year ended December 31, 2000 are independent of a medical contract.
- Concentrate on cross-selling additional non-medical products to existing non-medical customers including our asset accumulation customers. Many small and medium-sized businesses do not offer dental insurance to their employees. We believe the dental insurance market has the potential for sales growth.

#### PRODUCTS AND SERVICES

Our U.S. group insurance products and services include:

- life insurance;
- disability insurance;



- medical insurance;
- dental and vision insurance; and
- fee-for-service.

**GROUP LIFE INSURANCE.** Group life insurance provides coverage to employees and their dependents for a specified period. As of June 30, 2001, we had \$70.7 billion of group life insurance in force covering 2.8 million individuals. We carry both traditional group life insurance that does not provide for accumulation of cash values and interest-sensitive group life insurance, commonly known as group universal life, which provides for accumulation of cash values. Our group life insurance business remains focused on the traditional annually renewable term product. Group term life and group universal life accounted for 90% and 10%, respectively, of our total group life insurance in force as of June 30, 2001. According to the 2000 LIMRA International, Inc. Sales and In Force Reports, we were ranked first in the United States in terms of the number of contracts/employer groups for both sales and existing business in 2000.

**GROUP DISABILITY INSURANCE.** Group disability insurance provides partial replacement of earnings to insured employees who become disabled. Our group disability products include both short-term and long-term disability. Long-term disability represented 59% of our group disability premiums for the six months ended June 30, 2001. In addition, we provide disability management services, or rehabilitation services, to assist individuals in returning to work as quickly as possible following disability. We also work with disability claimants to improve the approval rate of Social Security benefits, thereby reducing payment of benefits by the amount of Social Security payments received. For claims incurred more than two years prior to June 30, 2001, we achieved an 88% approval rate for such Social Security benefits. Our group disability business was ranked seventh in the United States as of December 31, 2000 in terms of number of contracts/employer groups in force, according to the 2000 LIMRA International, Inc. Sales and In Force Reports.

**GROUP MEDICAL INSURANCE.** Group medical insurance provides partial reimbursement of medical expenses for insured employees and their dependents. Employees are responsible for deductibles, co-payments and co-insurance. We believe our products are well-positioned to address our customers' preference for a variety of provider choices and preferred provider discounts. We do not offer unrestricted indemnity and no longer offer the pure HMO model. We are considering entering into a reinsurance agreement to reduce the volatility of our group medical insurance earnings.

**GROUP DENTAL AND VISION INSURANCE.** Group dental and vision insurance plans provide partial reimbursement for dental and vision expenses. As of June 30, 2001, we had over 35,000 group dental and vision insurance plans in force. As of December 31, 2000, we were the largest group indemnity dental insurer in terms of 2000 sales based on total indemnity, and the largest in terms of number of contracts/employer groups in force in 2000 based on total indemnity, according to the 2000 LIMRA International, Inc. Sales and In Force Reports.

**FEE-FOR-SERVICE.** We offer administration of group disability, medical, dental and vision services on a fee basis to larger employers.

#### MARKETS AND DISTRIBUTION

We market our group life, disability, medical, dental and vision insurance products to small and medium-sized businesses to complement our retirement services and individual insurance products. We market our fee-for-service administration capabilities to larger employers that self-insure their employees' health insurance benefits.

We sell our group life, disability, dental and vision coverages in all 50 states and the District of Columbia. We have chosen to market our medical insurance in 36 states which we believe have attractive market conditions. We consider a market to be attractive if there is a lack of deep penetration by HMOs and a favorable regulatory environment. We continually adapt our products and pricing to meet local market conditions.

We distribute our group insurance products through independent benefit brokers, consultants, financial planners and the same channels that sell our U.S. asset accumulation products. To reach these independent benefit brokers, consultants and financial planners, we employ three types of wholesale distributors:

- our medical sales representatives;
- our non-medical sales representatives; and
- an independent wholesale organization, Rogers Benefit Group, dedicated to marketing group life, health and disability insurance products.

As of June 30, 2001, we had 81 medical and non-medical sales representatives and 32 service representatives in 58 offices. Our medical and non-medical sales representatives accounted for 63%, 60%, 64% and 69% of our group insurance sales for the six months ended June 30, 2001 and for the years ended December 31, 2000, 1999 and 1998, respectively. These representatives act as a unique combination of wholesalers and brokers. They are an integral part

of the sales process alongside the agent or independent broker. In addition to a high level of involvement in the sales process, the group sales force plays a key role in the ongoing servicing of the case by:

- providing local responsive services to our customers, such as renewing contracts, revising plans and solving any administrative issues;
- communicating the customers' needs and feedback to us; and
- helping employees understand the benefits of their plan.

Compensation for the group sales force is a blend of salary and production-based incentives.

Rogers Benefit Group is a marketing and service organization that represents major high quality insurance carriers specializing in individual and group medical programs, and group life, disability and dental plans. Our relationship with Rogers Benefit Group dates back to its creation in 1970. It accounted for 37%, 40%, 36% and 31% of our group insurance sales, for the six months ended June 30, 2001 and for the years ended December 31, 2000, 1999 and 1998, respectively.

#### MORTGAGE BANKING SEGMENT

We began our residential lending activities in 1936. Our Mortgage Banking segment is primarily engaged in residential loan production and loan servicing in the United States. Through our wholly owned subsidiary, Principal Residential Mortgage, Inc., or PRMI, we originate, purchase, securitize, sell and service mortgage loans. We principally originate "A" quality home mortgages and do not originate sub-prime mortgages to any material degree, nor do we service or purchase any sub-prime mortgage loans. "A" quality loans are generally defined as loans eligible for sale to the Federal National Mortgage Association, or Fannie Mae, Federal Home Loan Mortgage Corporation, or Freddie Mac and the Government National Mortgage Association, or Ginnie Mae. According to Inside Mortgage Finance, based on the unpaid balance of \$64.4 billion in mortgage loans in its servicing block, PRMI was ranked as the thirteenth largest mortgage servicer in the United States as of June 30, 2001 and was ranked thirteenth in production with \$15.0 billion of new loans for the six months ended June 30, 2001.

Our Mortgage Banking segment contributed 7%, 4%, 5% and 4% of our total operating revenues and 19%, 8%, 12% and 22% of our total operating earnings for the six months ended June 30, 2001 and the years ended December 31, 2000, 1999 and 1998, respectively. The table below shows operating revenues, operating earnings and assets of our Mortgage Banking segment by loan servicing and loan production for the periods indicated:

MORTGAGE BANKING SELECTED FINANCIAL HIGHLIGHTS								
	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,					
	2001		2000	1999	1998			
-----								
(\$ IN MILLIONS)								
-----								
OPERATING REVENUES:(1)								
Loan Servicing.....	\$ 181.0	62%	\$ 313.8	87%	\$ 286.5	72%	\$ 235.4	69%
Loan Production.....	112.1	38	46.0	13	111.8	28	105.2	31
Total.....	\$ 293.1	100%	\$ 359.8	100%	\$ 398.3	100%	\$ 340.6	100%
	=====	===	=====	===	=====	===	=====	===
OPERATING EARNINGS:								
Loan Servicing.....	\$ 33.5	49%	\$ 63.9	128%	\$ 29.3	52%	\$ 35.5	60%
Loan Production.....	35.3	51	(13.9)	(28)	27.5	48	23.3	40
Total.....	\$ 68.8	100%	\$ 50.0	100%	\$ 56.8	100%	\$ 58.8	100%
	=====	===	=====	===	=====	===	=====	===
ASSETS:								
Total.....	\$2,168.9	100%	\$1,556.3	100%	\$1,737.7	100%	\$1,810.4	100%
	=====	===	=====	===	=====	===	=====	===

(1) Excludes net realized capital gains and their impact on recognition of front-end fee revenues.

#### STRATEGY

We pursue a balanced approach encompassing both loan servicing and loan production activities. Periods of low interest rates increase the value and volume of our loan production activities, while high interest rates increase the value of our loan servicing rights since mortgage prepayments decline as interest rates rise.

We believe that residential mortgages play a central role in the financial planning activities of Americans, as home ownership is a high priority for many households. As such, residential mortgages represent a component of our overall portfolio of customer-driven financial products and services. Our strategic initiatives include:

#### LEVERAGE OUR STRONG SERVICING PLATFORM

- Concentrate on operating efficiencies. Our focus on servicing only "A" or "A-" quality loans ensures not only relatively high loan credit quality, but also allows us to better streamline our systems and processes. According to the 1999 Cost of Servicing Survey conducted by the Mortgage Bankers Association of America, we serviced 1,670 loans per employee compared to an industry average of 1,119 as of December 31, 1999. For the six months ended June 30, 2001, we serviced 1,684 loans per employee.
- Increase servicing revenue per loan. We have two sources of servicing revenues. First, we receive loan servicing fees from the guarantors or buyers of the mortgage-backed securities and loans we sell. Our servicing fee revenue per loan increased from \$329 at the end of 1997 to \$448 as of June 30, 2001, an increase of 36%. The second source of revenue is ancillary fees we receive from the sale of optional products and services to our mortgage customers. For the six months ended June 30, 2001, we generated \$16.19 per loan from the sale of such products and services, compared to \$9.44 per loan in 1998.
- Use technology to enhance our customer service. We offer both an Internet site and touch-tone phone access to loan information. Both systems allow our customers to initiate various information and account requests which are performed entirely electronically.

**RETAIN EXISTING CUSTOMERS.** We believe we can profit from having existing mortgage customers conduct repeat business with us, either by refinancing an existing loan or by obtaining financing for a new home purchase. We actively market refinance and new home purchase opportunities to our existing customers via direct customer approaches such as targeted mail campaigns, in-bound and out-bound telephone sales and web-based lending applications. We offer simplified loan application, processing and closing services to existing customers, thereby lowering the cost of refinancing to both the customer and to us. We also offer a new mortgage application process to existing customers with less documentation than would be required by another lender.

**CAPITALIZE ON THE CROSS-SALE OPPORTUNITIES WITH OUR OTHER LINES OF BUSINESS.** While we have historically operated our mortgage banking operations independently of our other businesses, as of June 30, 2001, 68,137 of our 631,004 mortgage customers owned one or more of our other products. We believe this demonstrates potential for the cross-sale of our retirement investments and insurance products and services to our residential mortgage customers. We further believe that there is potential to cross-sell our mortgage banking offerings to the approximately 12 million customers of our other lines of business that did not have a residential mortgage relationship with us as of June 30, 2001.

#### LOAN PRODUCTION

Our loan production strategy is to manage our four distribution channels, correspondent lending, retail origination, wholesale lending and Mortgage Direct, in a manner that is consistent with our loan servicing strategy. We obtain new customers through each of our four production channels, with the majority being obtained through our correspondent lending and wholesale lending operations. Our Mortgage Direct operation, which is primarily involved with the retention of current servicing portfolio customers, refinances current loans and makes new loans to customers on new properties they purchase.

We originate and purchase conventional mortgage loans, mortgage loans insured by the Federal Housing Administration, or FHA, and mortgage loans partially guaranteed by the Department of Veterans Affairs, or VA. A majority of our conventional loans are conforming loans that qualify for inclusion in guarantee programs sponsored by Fannie Mae or Freddie Mac. The remainder of the conventional loans are non-conforming loans, such as jumbo loans with an original balance in excess of \$275,000 or other loans that do not meet Fannie Mae or Freddie Mac guidelines. We neither originate nor purchase "B" or "C" mortgages, defined as lower credit quality loans. However, we are beginning to originate or purchase "A-" quality residential loans that are eligible for sale to Fannie Mae or Freddie Mac. We believe this segment presents opportunities to further penetrate the expanding U.S. housing market without presenting the types of risks inherent in the subprime sector.

The table below shows our loan production by loan type for the periods indicated:

MORTGAGE BANKING  
LOAN PRODUCTION BY LOAN TYPE

	FOR THE SIX MONTHS ENDED JUNE 30,	FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
	(\$ IN MILLIONS)			
<b>CONVENTIONAL LOANS:</b>				
Number of loans.....	74,458	35,418	56,731	64,630
Volume of loans.....	\$10,993.5	\$4,969.1	\$ 7,307.4	\$ 7,865.5
Percent of total volume.....	72%	60%	55%	65%
<b>FHA/VA LOANS:</b>				
Number of loans.....	37,355	31,093	57,592	44,009
Volume of loans.....	\$ 4,374.9	\$3,342.7	\$ 5,999.9	\$ 4,255.0
Percent of total volume.....	28%	40%	45%	35%
<b>TOTAL LOANS:</b>				
Number of loans.....	111,813	66,511	114,323	108,639
Volume of loans.....	\$15,368.4	\$8,311.8	\$13,307.3	\$12,120.5
Average loan amount (\$ in thousands).....	\$ 137.4	\$ 125.0	\$ 116.4	\$ 111.6

The table below shows our loan production by purpose and by interest rate type for the periods indicated:

MORTGAGE BANKING  
LOAN PRODUCTION BY PURPOSE AND INTEREST RATE TYPE

	FOR THE SIX MONTHS ENDED JUNE 30,	FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
	(\$ IN MILLIONS)			
Purchase.....	\$ 7,174.6	\$6,930.1	\$ 9,106.8	\$ 6,294.0
Refinance.....	8,193.8	1,381.7	4,200.5	5,826.5
<b>Total.....</b>	<b>\$15,368.4</b>	<b>\$8,311.8</b>	<b>\$13,307.3</b>	<b>\$12,120.5</b>
Fixed Rate.....	\$15,135.0	\$7,400.7	\$12,449.4	\$11,645.7
Adjustable Rate.....	144.4	854.1	683.8	388.9
Balloon.....	89.0	57.0	174.1	85.9
<b>Total.....</b>	<b>\$15,368.4</b>	<b>\$8,311.8</b>	<b>\$13,307.3</b>	<b>\$12,120.5</b>

We are actively engaged in the loan production business via the following distribution channels: correspondent lending; retail origination; wholesale and Mortgage Direct.

The table below shows our loan production by distribution channel for the periods indicated:

MORTGAGE BANKING  
LOAN PRODUCTION BY DISTRIBUTION CHANNEL

	FOR THE SIX MONTHS ENDED JUNE 30,	FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
	(\$ IN MILLIONS)			
<b>VOLUME OF LOANS:</b>				
Correspondent Lending.....	\$11,580.3	\$6,378.6	\$10,545.4	\$ 9,353.8
Retail Origination.....	955.5	734.4	1,088.8	1,721.1
Wholesale.....	2,617.9	1,079.7	1,247.1	761.3
Mortgage Direct.....	214.7	119.1	426.0	284.3
<b>Total.....</b>	<b>\$15,368.4</b>	<b>\$8,311.8</b>	<b>\$13,307.3</b>	<b>\$12,120.5</b>

**CORRESPONDENT LENDING.** As of June 30, 2001, we had contracts with 446 lending institutions across the United States to purchase prime credit quality loans on an ongoing basis. According to Inside Mortgage Finance, as of June 30, 2001, we were the seventh largest correspondent lender in the United States. High quality financial institutions are approved to do business with us only after we review their reputation, financial strength and lending expertise. Our "Correspondent Lending Service Center" on the Internet currently offers online access to loan registration, an interactive sellers' procedure manual, seller-specific rate/price quotations and simplified contact information. We are developing online technologies to offer automated underwriting systems, pipeline reporting and account management tools and electronic business-to-business capabilities for our correspondent sellers. Additionally, we are forging numerous alliances with third-party service providers to further streamline processes, improve productivity and provide outstanding customer service.

**RETAIL ORIGINATION.** Our retail channel originates prime credit quality mortgages through referrals from real estate agents, builders and personal contact with consumers through our nationwide network, which was comprised of 213 mortgage loan officers located in 55 offices as of June 30, 2001. We are developing automated exchange service agreements which will allow retail loan officers to establish reciprocal agreements with partners including realtors, builders, attorneys, title companies and others to and from our Internet website. This will enable us to build better relationships with such partners by providing access to relevant information via the Internet for their convenience.

**WHOLESALE.** Our wholesale channel, which we acquired in 1998, originates or purchases prime credit quality loans through 9 regional offices that worked directly with 1,491 participating mortgage loan brokers across the United States as of June 30, 2001. Mortgage loan brokers are approved only after a review of their reputation and mortgage lending expertise. Through the "Wholesale Lending Service Center" on our Internet website, wholesale lenders can retrieve contact information and seller specific interest rate quotations. We have developed plans and are working to provide online registration, automated underwriting system, pipeline reporting and account management services to our brokers. We are also developing electronic document delivery and execution capabilities for wholesale sellers to exchange secure documents with wholesale purchasers.

**MORTGAGE DIRECT.** Our Mortgage Direct channel originates prime credit quality mortgage loans through direct contact with current and new customers via telephone and the Internet. The goal of our Internet channel is to give our current customers access to a customer-focused website, allowing them to obtain home financing quickly, confidentially and at an attractive value, while preserving acceptable profit margins for us. We believe that providing current customers with choice, ease of access, convenient processes and simplified procedures will cause a growing percentage of our customers to choose us for all of their home financing needs.

#### LOAN UNDERWRITING

Our guidelines for underwriting conventional conforming loans comply with the underwriting criteria employed by Fannie Mae and Freddie Mac. Our guidelines for underwriting FHA-insured and VA-guaranteed loans comply with the criteria established by those government entities. Our underwriting guidelines and property standards for conventional non-conforming loans are based on the underwriting standards employed by private investors for such loans. In addition, conventional loans having a loan-to-value ratio greater than 80% at origination, which are originated or purchased by us, are required to have private mortgage insurance. Insurance is either paid for by the borrower or the lender. Our underwriting standards generally allow loan-to-value at origination of up to 97% for mortgage loans with an original principal balance of up to \$275,000. To determine whether a prospective borrower has sufficient monthly income available to meet: (1) the borrower's monthly obligation on the proposed mortgage loan and (2) monthly housing expenses and other financial obligations, we generally use the guidelines, techniques and technology tools provided by our investors.

#### SALE OF LOANS

As a mortgage banker, substantially all loans we originate or purchase are sold without recourse, subject in the case of VA loans to the limits of the VA's guaranty. Conforming conventional loans are generally pooled by us and exchanged for securities guaranteed by Fannie Mae or Freddie Mac. These securities are then sold to national or regional broker-dealers. Substantially all conventional loans securitized through Fannie Mae or Freddie Mac are sold, subject to representations and warranties made by us on a non-recourse basis, whereby foreclosure losses are generally a liability of Fannie Mae or Freddie Mac. We securitize substantially all of our FHA-insured and VA-guaranteed mortgage loans through Ginnie Mae. The FHA insures us against foreclosure loss and the VA provides partial guarantees against foreclosure loss. To guarantee timely and full payment of principal and interest on Fannie Mae, Freddie Mac and Ginnie Mae securities, we pay guarantee fees to these agencies.

#### LOAN SERVICING

We service residential mortgages in return for a servicing fee. Our servicing division receives and processes mortgage payments for home owners, remits payments to investors, holds escrow funds, contacts delinquent borrowers, supervises foreclosures and property dispositions and performs other miscellaneous duties related to loan

administration. We acquire only "A" or "A-" quality home mortgages for servicing. This practice simplifies the systems necessary for servicing and reduces the amount of time and money spent on collections and foreclosure administration activities. Our goal is to service, on a non-recourse basis, a majority of the loans that we originate. In addition, we periodically purchase bulk-servicing contracts, also on a non-recourse basis to us, on prime quality mortgage loans originated by other lenders. Our bulk purchases focus primarily on the acquisition of agency servicing packages. Factors which influence the management of the servicing portfolio include the expected long-term and short-term profitability of the servicing rights, customer retention objectives and the potential cross-selling of retirement investments and insurance products to home owners. Servicing contracts acquired through bulk purchases accounted for 27% of our mortgage servicing portfolio as of June 30, 2001.

The table below shows the composition of our servicing portfolio by type and performance for the periods indicated:

MORTGAGE BANKING  
COMPOSITION OF SERVICING PORTFOLIO BY TYPE AND PERFORMANCE

	FOR THE SIX MONTHS ENDED	AS OF DECEMBER 31,		
	JUNE 30,	2000	1999	1998
	2001	(\$ IN MILLIONS)		
Conventional Mortgage Loans.....	\$41,709.3	\$34,396.3	\$30,679.4	\$22,839.6
FHA-Insured Mortgage Loans.....	16,543.8	15,463.8	15,028.8	13,419.6
VA-Guaranteed Mortgage Loans.....	6,186.4	6,127.3	6,167.3	5,713.8
<b>Total Servicing Portfolio.....</b>	<b>\$64,439.5</b>	<b>\$55,987.4</b>	<b>\$51,875.5</b>	<b>\$41,973.0</b>
<b>DELINQUENT MORTGAGE LOANS AND PENDING FORECLOSURES AT PERIOD END(1):</b>				
30 Days.....	3.7%	4.4%	3.4%	4.3%
60 Days.....	0.8	1.2	1.1	1.2
90 Days or more.....	0.4	0.5	0.5	0.8
<b>Total Delinquencies.....</b>	<b>4.9%</b>	<b>6.1%</b>	<b>5.0%</b>	<b>6.3%</b>
Foreclosures Pending.....	1.2%	1.3%	1.1%	1.1%

(1) Expressed as a percentage of the total number of loans serviced excluding sub-serviced loans.

The table below shows the composition of our servicing portfolio by interest rate as of June 30, 2001:

MORTGAGE BANKING  
SERVICING PORTFOLIO BY INTEREST RATE  
AS OF JUNE 30, 2001

INTEREST RATE	PRINCIPAL BALANCE	PERCENTAGE OF TOTAL	AVERAGE MATURITY (YEARS)
		(\$ IN MILLIONS)	
7% and under.....	\$29,972.9	47%	24.5
7.01-8%.....	28,128.7	44	26.0
8.01-9%.....	6,050.5	9	25.4
9.01-10%.....	247.2	--	18.9
Over 10%.....	40.2	--	12.6
<b>Total.....</b>	<b>\$64,439.5</b>	<b>100%</b>	<b>25.2</b>

The weighted-average interest rate in our servicing portfolio as of June 30, 2001 was 7.27%. As of June 30, 2001, fixed rate loans comprised 95% of the servicing portfolio and the weighted-average interest rate of the fixed-rate loans was 7.26%.

The table below shows the geographic distribution of our loan servicing portfolio as of June 30, 2001:

MORTGAGE BANKING  
GEOGRAPHIC DISTRIBUTION OF LOAN SERVICING BY SIZE  
AS OF JUNE 30, 2001

	PERCENTAGE OF PRINCIPAL BALANCE SERVICED
-----	
California.....	10.8%
Texas.....	6.5
Virginia.....	5.6
Minnesota.....	4.8
Ohio.....	4.7
Pennsylvania.....	4.4
North Carolina.....	3.9
New Jersey.....	3.6
Florida.....	3.5
Colorado.....	3.4
Others(1).....	48.8
	-----
	100.0%
	=====

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(1) No other state constitutes more than 3.4%.

RISK MANAGEMENT

Because mortgage lending is subject to asset valuation risk associated with changes in interest rates, we manage and hedge our servicing assets and our "in process" mortgage loan production pipeline. Using a balanced blend of proprietary analytical models and purchased interest rate risk management tools, we have developed a risk management protocol designed to reduce volatility.

We use derivatives, such as interest rate swaps and floors, principal-only swaps, Treasury futures contracts and options on Treasury futures contracts to hedge a portion of our portfolio of mortgage servicing rights from prepayment risk associated with changes in interest rates. To further minimize our exposure to interest rate fluctuations, we seek a balance between loan servicing and loan production, which are counter cyclical in nature. Historically, during periods of low interest rates and the resulting increase in refinancings, revenue generated by mortgage originations generally offsets revenue loss related to prepayment of mortgages for which we provide servicing.

In the normal course of business, our Mortgage Banking segment protects its position in mortgages by taking positions in the options, futures and cash markets. We hedge in the cash market by entering into forward delivery contracts, which require us to deliver loans or mortgage-backed securities at a future date at a preset price. All risk management activity is reviewed and approved by a committee of our senior management.

SEASONALITY

The mortgage banking industry is generally subject to seasonal trends. These trends reflect the general national pattern of selling and reselling of homes, although refinancings tend to be less seasonal and more closely related to changes in interest rates. This activity typically peaks during the spring and summer seasons and declines to lower levels from mid-November through February.

CORPORATE AND OTHER SEGMENT

Our Corporate and Other segment manages the assets representing capital that has not been allocated to any other segment. These assets are primarily comprised of fixed income securities, common stock and real estate investments. Included among the common stock are our holdings in Coventry Health Care, Inc., which had a carrying value of \$134.6 million as of June 30, 2001. All debt service and interest expense and all inter-segment eliminations are included in this segment. The assets in excess of that needed by the four operating segments are held in the Corporate and Other segment.

Our Corporate and Other segment generated 1%, 1%, 1% and 5% of our total operating revenues and total operating earnings of \$32.1 million, \$67.7 million, \$9.5 million and operating loss of \$(44.3) million for the six months ended June 30, 2001 and for the years ended December 31, 2000, 1999 and 1998, respectively. The table below shows operating revenues, operating earnings and assets for our Corporate and Other segment for the periods indicated:

CORPORATE AND OTHER  
SELECTED FINANCIAL HIGHLIGHTS

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,	AS OF OR FOR THE YEAR ENDED DECEMBER 31,		
	2001	2000	1999	1998
	(\$ IN MILLIONS)			
OPERATING REVENUES(1).....	\$ 57.5	\$ 97.1	\$ 61.9	\$ 342.5
	=====	=====	=====	=====
OPERATING EARNINGS (LOSS).....	\$ 32.1	\$ 67.7	\$ 9.5	\$ (44.3)
	=====	=====	=====	=====
ASSETS.....	\$1,321.6	\$957.8	\$1,121.5	\$3,075.9
	=====	=====	=====	=====

(1) Total revenues, excluding net realized capital gains and their impact on recognition of front-end fee revenues.

COMPETITION

Competition in our operating segments is based on a number of factors, including service, product features, price, investment performance, commission structure, distribution capacity, financial strength ratings and name recognition. We compete for customers and distributors with a large number of financial services companies such as banks, mutual funds, broker-dealers, insurers and asset managers. Some of these companies offer a broader array of products, more competitive pricing, greater diversity of distribution sources, better brand recognition or, with respect to insurers, higher financial strength ratings. Some may also have greater financial resources with which to compete or may have better investment performance at various times.

Competition in the retirement services market is very fragmented. Our main competitors in this market include Fidelity, Nationwide, AXA, Mass Mutual and Manulife. We believe the infrastructure and system support needed to meet the needs of the small and medium-sized business market is a significant barrier to entry for our competitors. Many of our competitors in the mutual fund industry are larger, have been established for a longer period of time, offer less expensive products, have deeper penetration in key distribution channels and have more resources than we do. There were over 8,171 mutual funds in the United States as of December 31, 2000, according to the Investment Company Institute 2001 Mutual Fund Fact Book. The institutional asset management market has grown at a rapid pace over the last decade. Our primary competitors in this market are large institutional asset management firms, such as J.P. Morgan Chase, Morgan Stanley Asset Management and T. Rowe Price, many of which offer a broader array of investment products and services and are better known. The asset management business has relatively few barriers to entry and continually attracts new entrants. The variable annuity market is also highly competitive. As we expand into additional distribution channels for this product, we will face strong competition from Nationwide and Hartford. Competition in the international markets in which we operate comes primarily from local financial services firms and other international companies operating on a stand-alone basis or in a partnership with local firms, including ING, AXA, Allianz and AIG. In the highly competitive group life and health insurance business, our competitors include other insurers and health maintenance organizations such as The Northwestern Mutual Life Insurance Company, Manulife and Aetna. The mortgage banking industry is also highly competitive and fragmented and we compete with other mortgage bankers, commercial banks, savings and loan associations, credit unions and insurance companies such as Countrywide and Wells Fargo.

We believe we distinguish ourselves from our competitors through our:

- full-service platform;
- strong customer relationships;
- focus on financial performance; and
- performance-oriented culture.

On November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act of 1999, implementing fundamental changes in the regulation of the financial services industry in the United States. The Act permits mergers that combine commercial banks, insurers and securities firms under one holding company. Under the Act, national



banks retain their existing ability to sell insurance products in some circumstances. In addition, bank holding companies that qualify and elect to be treated as "financial holding companies" may engage in activities, and acquire companies engaged in activities, that are "financial" in nature or "incidental" or "complementary" to such financial activities. This includes acting as principal, agent or broker in selling life, property and casualty and other forms of insurance, including annuities. A financial holding company can own any kind of insurance company or insurance broker or agent, but its bank subsidiary cannot own the insurance company. Under state law, the financial holding company would need to apply to the insurance commissioner in the insurer's state of domicile for prior approval of the acquisition of the insurer. With the passage of the Gramm-Leach-Bliley Act, among other things, bank holding companies may acquire insurers, and insurance holding companies may acquire banks. The ability of banks to affiliate with insurance companies in the United States may materially adversely affect all of our product lines by substantially increasing the number, size and financial strength of potential competitors.

RATINGS

Insurance companies are assigned financial strength ratings by rating agencies based upon factors relevant to policyholders. Ratings provide both industry participants and insurance consumers meaningful information on specific insurance companies. Higher ratings generally indicate financial stability and a stronger ability to pay claims.

Principal Life has been assigned the following ratings as of June 30, 2001:

RATING AGENCY	FINANCIAL STRENGTH RATING	RATING STRUCTURE
A.M. Best Company, Inc.	A+ ("Superior") with a stable outlook	Second highest of 16 rating levels
Fitch IBCA, Inc. (formerly Duff & Phelps Credit Rating Company)	AA+ ("Very Strong") with a stable outlook	Second highest of 24 rating levels
Moody's Investors Service	Aa2 ("Excellent") with a stable outlook	Third highest of 21 rating levels
Standard & Poor's Rating Services	AA ("Very Strong") with a stable outlook	Third highest of 21 rating levels

A.M. Best's ratings for insurance companies range from "A++" to "S". A.M. Best indicates that "A++" and "A+" ratings are assigned to those companies that in A.M. Best's opinion have achieved superior overall performance when compared to the norms of the life insurance industry and have demonstrated a strong ability to meet their policyholder and other contractual obligations. Fitch's ratings for insurance companies range from "AAA" to "D". Fitch indicates that "AA" ratings are assigned to those companies that have demonstrated financial strength and a very strong capacity to meet policyholder and contractholder obligations on a timely basis. Moody's ratings for insurance companies range from "Aaa" to "C". Moody's indicates that "A" ("Excellent") ratings are assigned to those companies that have demonstrated excellent financial security. Standard & Poor's ratings for insurance companies range from "AAA" to "R". Standard & Poor's indicates that "AA" ratings are assigned to those companies that have demonstrated very strong financial security. In evaluating a company's financial and operating performance, these rating agencies review its profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its policy reserves and the experience and competency of its management.

We believe that our strong ratings are an important factor in marketing our products to our distributors and customers, since ratings information is broadly disseminated and generally used throughout the industry. Our ratings reflect each rating agency's opinion of our financial strength, operating performance and ability to meet our obligations to policyholders and are not evaluations directed toward the protection of investors. Such ratings are neither a rating of securities nor a recommendation to buy, hold or sell any security, including our common stock.

REINSURANCE

Principal Life follows the standard industry practice of ceding portions of its life insurance risks to other insurance companies. This permits us to write larger policies than we would otherwise be comfortable retaining. Principal Life usually enters into annually renewable term insurance contracts, which focus on pure mortality risk. As of December 31, 2000, the amount of statutory premiums ceded to third-party reinsurers totaled \$44.1 million. Principal Life's primary third-party reinsurer of individual life insurance policies at December 31, 2000 was Transamerica Occidental Life, which was rated A+ by A.M. Best. As of December 31, 2000, the individual life insurance in force ceded to Transamerica Occidental Life Insurance Company was \$13.4 billion, which represented 9% of our total net life insurance in force. Of the remaining individual life reinsurers, no reinsurer has more than two percent of the total net insurance in force.

For U.S. individual life insurance, we reinsure mortality risk in excess of \$7.5 million on any single life, whether that amount is from only one policy or multiple policies. For individual disability insurance, we generally retain between \$4,000 and \$10,000 of monthly benefit per insured life depending on the type of coverage.

We acquire reinsurance on both our U.S. group life and disability insurance. For group life insurance, we purchase catastrophic coverage for claims in excess of \$1.0 million where three or more insureds are involved in a catastrophe. We also reinsure accidental death claims in excess of \$500,000 for our group universal life product. For group disability, we retain no more than \$3,500 of monthly benefit per insured life for cases with 2,000 or fewer employees. On larger cases, we cede 80% of the claim risk. Effective July 1, 2000, we entered into a reinsurance agreement with General & Cologne Life Re of America to reinsure 100% of our Medicare supplement insurance business. We do not reinsure our group dental or group vision products.

Reinsurance does not discharge our obligation to pay policy claims on the reinsured business. We remain responsible for paying claims, to the extent the reinsurer fails to pay such claims. As a result, we seek to work only with highly rated reinsurers that have passed an internal due diligence review. Nevertheless, there can be no assurance that all our reinsurers will pay the claims we make against them.

#### INSURANCE RESERVES

We establish and report liabilities on our balance sheet to meet our future obligations using both actuarial and GAAP principles. The reserves are based on actuarially recognized methods using prescribed mortality and morbidity tables and assumptions for estimating future policy benefits and claim experience. We expect these reserve amounts, along with future premiums to be received on the policy and investment earnings on these amounts, to be sufficient to meet our contractual and policy obligations. Reserves include amounts for claims incurred but not yet reported, claims reported but not yet paid and claims in the process of settlement. Our GAAP-based reserves may vary from those calculated using statutory accounting practices.

#### GROUP HEALTH INSURANCE RESERVES

The liability for unpaid group health claims, including medical, dental and short term disability insurance, is an estimate of the ultimate net cost of both reported and unreported losses not yet settled. We estimate this liability using actuarial analyses and case basis evaluations. The primary reserve technique is an evaluation of historical claim runout patterns and includes a provision for adverse claim development. We also consider factors such as new sales, terminations, seasonality, medical trend, claim backlog and past estimate accuracy. Although considerable variability is inherent in such estimates, we believe that the liability for unpaid claims is adequate. These estimates are continually reviewed and, as adjustments to this liability become necessary, such adjustments are reflected in current operations.

#### DISABILITY INSURANCE RESERVES

Reserves for long term disability insurance represent the present value of benefits for current claimants. Claim benefit payments on long term disability insurance policies consist of payments made monthly, in accordance with the contractual terms of the policy. These payments begin at the claimant's eligibility date as defined in the policy and end upon the earliest of the claimant's recovery, the expiration of contract limitations included in the policy or the claimant's death. The liability is estimated using industry mortality and morbidity data, adjusted for our experience under these policies and discounted at an appropriate rate of interest. Most policies provide for an elimination period between the occurrence of the event causing a claimant's disability and the date when such a claimant is eligible to receive disability payments. In addition, some claims may not be filed promptly on the eligibility date under the policy. Reserves for these incurred but not reported claims are based upon industry factors for disability incidence, rates of termination from disability and interest rates as modified by our experience under these policies.

#### LIFE INSURANCE RESERVES

We calculate reserves for incurred but unreported claims using our historical loss experience with due consideration to current in force volumes. Reserves for claims that are in course of settlement and/or resisted are calculated on a similar basis. The life waiver reserve liability measures the present value of waiver of premium benefits under our group life and group universal life insurance contracts. We use industry mortality and morbidity tables and an appropriate rate of interest discount to calculate this liability. Reserves for interest-sensitive life insurance are equal to cumulative premiums less charges plus interest which represents the account balances that accrue to the benefit of the policyholders. The reserve is identical to the current value of the customer's account on deposit with us.

#### UNDERWRITING AND PRICING

We follow detailed underwriting practices and procedures to assess and quantify the nature and size of risks we are willing to accept as well as the amount and type of reinsurance level appropriate for a particular type of risk.

For U.S. individual life insurance, the level of medical and other data collected on the insured varies by the size of the death benefit requested. For small death benefits, we gather limited medical information. For large death benefits, we require extensive medical, financial and other data from the insured. These practices and procedures are designed to result in policies that produce mortality experience consistent with the assumptions used in pricing the product. The

pricing of our products varies depending on the age, occupational classification, type/amount of coverage/features purchased, and additional ratings or exclusions based on medical history. For individual cases, we underwrite each prospective insured based on the client's occupation, financial and medical history.

For U.S. group medical insurance, we have created a sophisticated claim system that has the ability to automatically adjudicate a percentage of our claims without claims examiner intervention. We receive and convert claims to an electronic and imaged format to enable a paperless environment and to enhance work flow processes. Once the claim is in the system, it is identified to the member's account, verifying eligibility. We then determine if the services are covered under the contract and the amount of benefit payable, using the contract information built into our system. The adjudication process can be completed automatically by the system, if the claim meets all system requirements. If the claim cannot be processed automatically by the system, it will be assigned to a claims examiner to process. Once the benefit has been determined, a disbursement or explanation relative to our actions is submitted. As a quality control measure, we review selected claims. For group insurance sold to smaller employers, those with fewer than 50 employees, we obtain individual employee health statements that are used to determine the initial medical premium for the group or for non-medical coverages or to determine whether we will decline the business. For larger groups, we assess the health of the group through a variety of sources such as employee health statements, risk appraisal questionnaire or prior claim history.

For all of our U.S. individual insurance and group insurance products, we base our underwriting practices on the historical claims experience for that particular product. This experience includes not only the historical mortality and/or morbidity experience of our existing individual insurance contracts, but also the experience of the overall individual insurance industry and the general population. We actively monitor our underwriting standards relative to those of our competitors and our emerging claims experience to mitigate our exposure to higher risk business and to stay abreast of market trends. Our underwriters evaluate policy applications on the basis of the information provided by the applicant and others. We use a variety of medical tests to evaluate policy applications, depending on the size of the policy, the age of the applicant and other factors.

Product pricing is reflective of our underwriting standards and is based on our expected policyholder benefits, expenses, persistency and investment returns. We designed product specifications to protect us against greater than expected mortality and morbidity experience. We review pricing frequently to ensure that it is consistent with recent claims experience. We also employ both prospective and retroactive experience rating. Experience rating is the process by which the premium charged to a group policyholder reflects a credit for positive historical experience or a charge for poor experience. Small group pricing must also meet stringent regulatory requirements.

In developing pricing proposals for new general account guaranteed investment contracts, our underwriters estimate both base-line cash flows and also likely variance from the base-line due to plan participants reallocating assets from the "stable value" option of their defined contribution plans. Our underwriters utilize customized pricing models that generate plan-specific risk charges for each customer's book value payment provision. If these pricing models project the risk of losses exceeding customary thresholds, instead of rejecting the business, our underwriters can modify the proposal by suggesting the use of risk reduction techniques designed to shift some of the risk of redemptions back to the plan or to a third-party.

We underwrite immediate annuities using recent mortality experience and an assumption of continued improvement in longevity. We underwrite deferred annuities by analyzing not only mortality risk but also the expected time to retirement.

In Argentina, Chile and Mexico, we use underwriting and pricing practices appropriate for the specific market where we conduct our operations.

#### PROPERTIES

We own 29 properties in our home office complex in Des Moines, Iowa and in various other locations. We lease office space for various offices located throughout the United States and internationally. The normal lease term is 3 to 5 years, but some leases have terms of up to 10 years. Our annual rental expense under these leases aggregated approximately \$38.1 million for leases in place as of June 30, 2001. We believe that our owned and leased properties are suitable and adequate for our current business operations.

#### LEGAL PROCEEDINGS

We are regularly involved in litigation, both as a defendant and as a plaintiff but primarily as a defendant. Litigation naming us as a defendant ordinarily arises out of our business operations as a provider of medical insurance, life insurance, annuities and residential mortgages. In addition, state regulatory bodies, such as state insurance departments, the SEC, the National Association of Securities Dealers, Inc., the Department of Labor and other regulatory bodies regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, ERISA and laws governing the activities of broker-dealers.

Recently, companies in the life insurance business have faced extensive claims, including class-action lawsuits, alleging improper life insurance sales practices. Principal Life is currently a defendant in two purported class-action lawsuits alleging improper sales practices. We have reached an agreement in principle to settle both of those lawsuits. The settlement has received court approval. We have established reserves at a level we believe sufficient to cover the cost of the settlement. A number of persons and entities who were eligible to be class members have excluded themselves from the class (or "opted out"), as the law permits them to do. We have been notified that some of those who opted out from the class will file lawsuits and make claims similar to those addressed by the settlement. Similar opt-out lawsuits have been brought against other life insurance companies as a result of settlement of similar class-action lawsuits. Defense of these lawsuits may cause us to incur significant costs. At this time, we are not able to estimate the number of such lawsuits that may be filed, the costs of defending the lawsuits or whether our defense will be successful.

A lawsuit was filed on September 27, 2001 in the United States District Court for the Northern District of Illinois, seeking damages and other relief on behalf of a putative class of policyholders based on allegations that the plan of conversion violates the United States Constitution. The action is captioned Esther L. Gayman v. Principal Mutual Holding Company, et al. We believe that there are meritorious defenses to the plaintiff's claims and we intend vigorously to contest all of the plaintiff's claims. We are not presently aware of any other lawsuits challenging the plan. There can be no assurance, however, that additional lawsuits will not be commenced.

While we cannot predict the outcome of any pending or future litigation, examination or investigation, we do not believe that any pending matter will have a material adverse effect on our business, financial condition or results of operations.

#### CUSTOMERS

We had approximately thirteen million customers as of June 30, 2001, which include employer sponsors of retirement and group insurance products and services, employees and their covered dependents under employee benefit arrangements, institutional investment management clients, individual insurance policyholders, residential mortgage loan borrowers, mutual fund shareholders and banking customers.

#### EMPLOYEES

As of June 30, 2001, we had 17,646 employees. None of our employees is subject to collective bargaining agreements governing employment with us. We believe that our employee relations are satisfactory.

## INVESTMENTS

We had total consolidated assets as of June 30, 2001 of \$85.2 billion, of which \$44.4 billion were invested assets. The rest of our total consolidated assets are comprised primarily of separate account assets for which we do not bear investment risk. Because we generally do not bear any investment risk on assets held in separate accounts, the discussion and financial information below does not include such assets. Of our invested assets, \$43.2 billion were held by our U.S. operations and the remaining \$1.2 billion were held by our International Asset Management and Accumulation segment.

### U.S. INVESTMENT OPERATIONS

Our U.S. invested assets are managed by Principal Capital Management, a subsidiary of Principal Life. Our primary investment objective is to maximize after-tax returns consistent with acceptable risk parameters. We seek to protect policyholders' benefits by optimizing the risk/return relationship on an ongoing basis, through asset/liability matching, reducing the credit risk, avoiding high levels of investments that may be redeemed by the issuer, maintaining sufficiently liquid investments and avoiding undue asset concentrations through diversification. We are exposed to three primary sources of investment risk:

- credit risk, relating to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest;
- interest rate risk, relating to the market price and/or cash flow variability associated with changes in market yield curves; and
- equity risk, relating to adverse fluctuations in a particular common stock.

Our ability to manage credit risk is essential to our business and our profitability. We devote considerable resources to the credit analysis of each new investment. We manage credit risk through industry, issuer and asset class diversification. Our Investment Committee, appointed by our board of directors, establishes all investment policies and reviews and approves all investments. There are nine members on the Investment Committee, two of whom are members of our board of directors. The remaining seven members are senior management members representing various areas of our company.

Our Fixed Income Securities Committee, consisting of fixed income securities senior management members, approves the credit rating for the fixed maturity securities we purchase. Teams specializing in residential mortgage-backed securities, commercial mortgage-backed securities and public below investment grade securities monitor these investments. We establish a credit reviewed list of approved public issuers to provide an efficient way for our portfolio managers to purchase liquid bonds for which credit review has already been completed. Issuers remain on the list for 6 months unless removed by our analyst. The analyst monitors issuers on the list on a continuous basis with a formal review documented every 6 months.

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

- material declines in the issuer's revenues or margins;
- significant management or organizational changes;
- significant uncertainty regarding the issuer's industry;
- debt service coverage or cash flow ratios that fall below industry-specific thresholds;
- violation of financial covenants; and
- other business factors that relate to the issuer.

A dedicated risk management team is responsible for centralized monitoring of the commercial mortgage portfolio. We apply a variety of strategies to minimize credit risk in our commercial mortgage loan portfolio. When considering the origination of new commercial mortgage loans, we review the cash flow fundamentals of the property, make a physical assessment of the underlying security, conduct a comprehensive market analysis and compare against industry lending practices. We use a proprietary risk rating model to evaluate all new and a majority of existing loans within the portfolio. The proprietary risk model is designed to stress projected cash flows under simulated economic and market downturns. Our lending guidelines are designed to encourage 75% or less loan-to-value ratios and a debt service coverage ratio of at least 1.2 times. We analyze investments outside of these guidelines based on cash flow quality, tenancy and other factors. From 1998 through June 30, 2001, the weighted average loan-to-value ratio at origination for brick and mortar commercial mortgages in our portfolio was in the 65%-68% range and debt service coverage ratios at loan inception in the 1.6-1.7 times range.

We have limited exposure to equity risk in our common stock portfolio. Equity securities accounted for only 1% of our U.S. invested assets as of June 30, 2001.

Our investment decisions and objectives are a function of the underlying risks and product profiles of each primary business operation. In addition, we diversify our product portfolio offerings to include products that contain features that will protect us against fluctuations in interest rates. Those features include adjustable crediting rates, policy surrender charges and market value adjustments on liquidations. For further information on our management of interest rate risk, see "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Quantitative and Qualitative Information about Market Risk".

OVERALL COMPOSITION OF U.S. INVESTED ASSETS

U.S. invested assets as of June 30, 2001 were predominantly of high quality and broadly diversified across asset class, individual credit, industry and geographic location. As shown in the following table, the major categories of U.S. invested assets are fixed maturity securities and commercial mortgages. The remainder is invested in real estate, equity securities and other assets. In addition, policy loans are included in our invested assets. We combined our invested assets in the Closed Block with invested assets outside the Closed Block in view of the similar asset quality characteristics of the two portfolios. The following discussion analyzes the composition of U.S. invested assets, which includes \$4,014.6 million in invested assets of the Closed Block as of June 30, 2001, but excludes invested assets of the participating separate accounts.

U.S. INVESTED ASSETS

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)							
Fixed maturity securities, available-for-sale								
Public.....	\$17,147.6	40%	\$14,263.6	35%	\$ 9,632.8	24%	\$ 8,157.6	21%
Private.....	11,356.4	26	11,611.4	28	12,951.5	32	13,674.9	34
Equity securities, available-for-sale.....	539.4	1	666.0	2	768.1	2	995.7	2
Mortgage loans								
Commercial.....	10,340.7	24	10,775.3	26	12,588.9	31	12,157.2	31
Residential.....	1,023.3	2	550.5	1	651.0	2	997.4	2
Real estate held for sale.....	653.1	2	695.4	2	1,033.4	3	1,049.8	3
Real estate held for investment.....	577.2	1	696.4	2	1,167.8	3	1,535.4	4
Policy loans.....	820.1	2	803.6	2	780.5	2	766.2	2
Other investments.....	786.9	2	681.2	2	514.0	1	339.8	1
Total invested assets.....	\$43,244.7	100%	\$40,743.4	100%	\$40,088.0	100%	\$39,674.0	100%
Cash and cash equivalents.....	237.1		750.1		368.4		416.2	
Total invested assets and cash.....	\$43,481.8		\$41,493.5		\$40,456.4		\$40,090.2	

We actively manage public fixed maturity securities, including our portfolio of residential mortgage-backed securities, in order to provide liquidity and enhance yield and total return. Our residential mortgage-backed securities are managed to ensure that the securities we hold trade close to or below par in order to manage prepayment risk. This active management has resulted in the realization of capital gains and losses with respect to such investments. In 1999 and 1998, we repositioned our investment portfolio by selling invested assets with lower yields, primarily equity securities and real estate, and reinvesting the proceeds in assets with higher yields, primarily debt securities.

U.S. INVESTMENT RESULTS

The yield on U.S. invested assets and on cash and cash equivalents, excluding net realized gains and losses, was 7.7% as of June 30, 2001 and 7.5%, 7.4% and 7.2% for the years ended December 31, 2000, 1999 and 1998, respectively.

The table below illustrates the yields on average assets for each of the components of our investment portfolio for the six months ended June 30, 2001, and the years ended December 31, 2000, 1999 and 1998:

U.S. INVESTED ASSETS  
YIELDS BY ASSET TYPE

	AS OF OR FOR THE SIX MONTHS ENDED JUNE 30,				AS OF OR FOR THE YEAR ENDED DECEMBER 31,			
	2001		2000		1999		1998	
	YIELD	AMOUNT	YIELD	AMOUNT	YIELD	AMOUNT	YIELD	AMOUNT
	----- (\$ IN MILLIONS)							
Fixed maturity securities, available-for-sale								
Gross investment income(1).....	7.7%	\$ 1,045.0	7.5%	\$ 1,813.3	7.4%	\$ 1,651.4	7.2%	\$ 1,546.0
Net realized capital gains (losses).....	(0.6)	(77.5)	(0.5)	(129.6)	(0.5)	(104.3)	0.1	28.8
Total.....		\$ 967.5		\$ 1,683.7		\$ 1,547.1		\$ 1,574.8
Ending assets (at carrying value).....		\$28,504.0		\$25,875.0		\$22,584.3		\$21,832.5
Equity securities, available-for-sale								
Gross investment income(1).....	2.3%	\$ 6.9	9.4%	\$ 67.1	4.4%	\$ 39.2	2.7%	\$ 30.5
Net realized capital gains (losses).....	(19.1)	(57.6)	11.2	80.3	43.2	381.4	27.3	302.7
Total.....		\$ (50.7)		\$ 147.4		\$ 420.6		\$ 333.2
Ending assets (at carrying value).....		\$ 539.4		\$ 666.0		\$ 768.1		\$ 995.7
Mortgage loans -- Commercial								
Gross investment income(1).....	8.0%	\$ 422.1	8.2%	\$ 955.6	8.1%	\$ 1,005.8	8.5%	\$ 1,053.8
Net realized capital gains (losses).....	0.3	14.9	0.1	8.6	(0.1)	(8.4)	0.1	6.3
Total.....		\$ 437.0		\$ 964.2		\$ 997.4		\$ 1,060.1
Ending assets (at carrying value).....		\$10,340.7		\$10,775.3		\$12,588.9		\$12,157.2
Mortgage loans -- Residential								
Gross investment income(1).....	7.3%	\$ 28.7	9.3%	\$ 56.1	11.9%	\$ 98.3	10.3%	\$ 89.2
Net realized capital gains (losses).....	--	--	--	--	--	--	--	--
Total.....		\$ 28.7		\$ 56.1		\$ 98.3		\$ 89.2
Ending assets (at carrying value).....		\$ 1,023.3		\$ 550.5		\$ 651.0		\$ 997.4
Real estate								
Gross investment income(1).....	15.3%	\$ 100.0	9.5%	\$ 170.8	7.8%	\$ 187.1	5.6%	\$ 143.2
Net realized capital gains (losses).....	--	(0.3)	4.6	82.3	2.4	56.4	4.7	120.6
Total.....		\$ 99.7		\$ 253.1		\$ 243.5		\$ 263.8
Ending assets (at carrying value).....		\$ 1,230.3		\$ 1,391.8		\$ 2,201.2		\$ 2,585.2
Policy loans								
Gross investment income(1).....	7.2%	\$ 29.4	7.0%	\$ 55.1	6.5%	\$ 50.2	6.7%	\$ 50.9
Net realized capital gains (losses).....	--	--	--	--	--	--	--	--
Total.....		\$ 29.4		\$ 55.1		\$ 50.2		\$ 50.9
Ending assets (at carrying value).....		\$ 820.1		\$ 803.6		\$ 780.5		\$ 766.2
Cash and cash equivalents								
Gross investment income(1).....	6.2%	\$ 15.4	4.3%	\$ 24.0	5.1%	\$ 20.0	1.1%	\$ 5.1
Net realized capital gains (losses).....	--	--	(0.5)	(2.7)	--	(0.1)	(0.1)	(0.2)
Total.....		\$ 15.4		\$ 21.3		\$ 19.9		\$ 4.9
Ending assets (at carrying value).....		\$ 237.1		\$ 750.1		\$ 368.4		\$ 416.2
Other investments								
Gross investment income(1).....	8.4%	\$ 30.9	10.4%	\$ 62.0	9.2%	\$ 39.4	47.3%	\$ 106.5
Net realized capital gains (losses).....	(4.8)	(17.7)	16.4	98.2	16.6	70.8	(2.6)	(5.9)
Total.....		\$ 13.2		\$ 160.2		\$ 110.2		\$ 100.6
Ending assets (at carrying value).....		\$ 786.9		\$ 681.2		\$ 514.0		\$ 339.8
Total before investment expenses								
Gross investment income.....	7.9%	\$ 1,678.4	7.8%	\$ 3,204.0	7.7%	\$ 3,091.4	7.5%	\$ 3,025.2
Net realized capital gains (losses).....	(0.7)	(138.2)	0.3	137.1	1.0	395.8	1.1	452.3
Total.....		\$ 1,540.2		\$ 3,341.1		\$ 3,487.2		\$ 3,477.5
Investment expenses.....	0.2%	\$ 53.0	0.3%	\$ 136.7	0.3%	\$ 113.5	0.3%	\$ 139.2
Net investment income.....	7.7%	\$ 1,625.4	7.5%	\$ 3,067.3	7.4%	\$ 2,977.9	7.2%	\$ 2,886.0

(1) Yields, which are annualized for interim periods, are based on quarterly average asset carrying values for the six months ended June 30, 2001, and annual average asset carrying values for the years ended December 31, 2000, 1999 and 1998.

We have classified all of our fixed maturity and equity securities as available-for-sale. Accordingly, we mark such securities to market, with unrealized gains and losses excluded from earnings and reported as a separate component of equity on our balance sheet. We write down to fair value securities whose value is deemed other than temporarily



impaired. We record writedowns as realized losses included in earnings and adjust the cost basis of such securities to fair value. The new cost basis is not changed for subsequent recoveries in value.

Fixed maturity securities consist of short-term investments, publicly traded debt securities, privately placed debt securities and small amounts of redeemable preferred stock, and represented 66% of total U.S. invested assets as of June 30, 2001 and 63%, 56% and 55% as of December 31, 2000, 1999 and 1998, respectively. The fixed maturity securities portfolio was comprised, based on carrying amount, of 60% in publicly traded fixed maturity securities and 40% in privately placed fixed maturity securities as of June 30, 2001, and 55% in publicly traded fixed maturity securities and 45% in privately placed fixed maturity securities as of December 31, 2000. Included in the privately placed category as of June 30, 2001 were \$3.6 billion of securities eligible for resale to qualified institutional buyers under Rule 144A under the Securities Act of 1933. Fixed maturity securities were diversified by category of issuer as of June 30, 2001, and for the years ended December 31, 2000, 1999 and 1998 as shown in the table below:

U.S. INVESTED ASSETS  
FIXED MATURITY SECURITIES BY TYPE OF ISSUER

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
(\$ IN MILLIONS)								
U.S. Treasury securities and obligations of U.S. Government corporations and agencies.....	\$ 9.2	--%	\$ 21.3	--%	\$ 161.3	1%	\$ 300.0	1%
States and political subdivisions.....	299.5	1	295.7	1	167.5	1	147.7	1
Non-U.S. governments.....	637.9	2	604.3	2	490.4	2	295.2	1
Corporate-public.....	11,621.3	41	8,740.8	34	5,104.3	22	3,925.1	18
Corporate-private.....	9,485.4	33	9,796.6	38	11,218.0	50	12,085.7	56
Mortgage-backed securities and other asset backed securities.....	6,450.7	23	6,416.3	25	5,442.8	24	5,078.8	23
Total fixed maturities.....	\$28,504.0	100%	\$25,875.0	100%	\$22,584.3	100%	\$21,832.5	100%

The international exposure in our U.S. invested assets totaled \$3,870.3 million, or 14% of total fixed maturity securities, as of June 30, 2001, comprised of corporate and foreign government fixed maturity securities. Of the \$3,870.3 million, investments totaled \$1,052.7 million in the United Kingdom, \$741.2 million in the continental European Union, \$484.1 million in Asia, \$409.2 million in South America, \$340.5 million in Australia and \$25.6 million in Japan. The remaining \$817.0 million was invested in 16 other countries. All international fixed maturity securities held by our U.S. operations are either denominated in U.S. dollars or have been swapped into U.S. dollar equivalents. Our international investments are analyzed internally by country and industry credit investment professionals. We control concentrations using issuer and country level exposure benchmarks, which are based on the credit quality of the issuer and the country. Our investment policy limits total international fixed maturity securities investments to 15% of total statutory general account assets with a 4% limit in emerging markets.

The Securities Valuation Office of the NAIC evaluates most of the fixed maturity securities that we and other U.S. insurance companies hold. The Securities Valuation Office evaluates the bond investments of insurers for regulatory reporting purposes and assigns securities to one of six investment categories. The NAIC DESIGNATIONS closely mirror the nationally recognized securities rating organizations' credit ratings for marketable bonds. NAIC Designations 1 and 2 include bonds considered investment grade by such rating organizations. Bonds are considered investment grade when rated "Baa3" or higher by Moody's, or "BBB-" or higher by Standard & Poor's. NAIC Designations 3 through 6 are referred to as below investment grade. Bonds are considered below investment grade when rated "Ba1" or lower by Moody's, or "BB+" or lower by Standard & Poor's.

The tables below present our publicly traded, privately placed and total fixed maturity securities by NAIC Designation and the equivalent ratings of the nationally recognized securities rating organizations as of June 30, 2001, and December 31, 2000, 1999 and 1998, as well as the percentage, based on estimated fair value, that each designation comprises:

U.S. INVESTED ASSETS  
PUBLICLY TRADED FIXED MATURITY SECURITIES BY CREDIT QUALITY

NAIC RATING	RATING AGENCY EQUIVALENT	AS OF JUNE 30, 2001			AS OF DECEMBER 31, 2000		
		AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT
-----							
(\$ IN MILLIONS)							
1	Aaa/Aa/A.....	\$ 9,913.2	\$10,238.7	60%	\$9,029.4	\$ 9,283.0	65%
2	Baa.....	5,971.5	6,103.5	36	4,432.3	4,492.8	32
3	Ba.....	644.2	615.1	4	451.7	434.1	3
4	B.....	83.4	83.4	--	44.4	21.9	--
5	Caa and lower.....	94.9	78.3	--	27.7	27.3	--
6	In or near default.....	48.4	28.6	--	14.9	4.5	--
Total public fixed maturities...		\$16,755.6	\$17,147.6	100%	\$14,000.4	\$14,263.6	100%
		=====	=====	===	=====	=====	===

NAIC RATING	AS OF DECEMBER 31, 1999			AS OF DECEMBER 31, 1998			
	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	
-----							
(\$ IN MILLIONS)							
1	\$6,991.9	\$6,888.4	72%	\$6,051.4	\$6,294.3	77%	
2	2,458.3	2,424.8	25	1,423.9	1,491.7	19	
3	234.8	233.0	3	325.2	345.2	4	
4	35.7	36.0	--	6.8	6.5	--	
5	27.3	28.3	--	14.9	3.8	--	
6	58.0	22.3	--	50.9	16.1	--	
		\$9,806.0	\$9,632.8	100%	\$7,873.1	\$8,157.6	100%
		=====	=====	===	=====	=====	===

U.S. INVESTED ASSETS  
PRIVATELY PLACED FIXED MATURITY SECURITIES BY CREDIT QUALITY

NAIC RATING	RATING AGENCY EQUIVALENT	AS OF JUNE 30, 2001			AS OF DECEMBER 31, 2000		
		AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT
-----							
(\$ IN MILLIONS)							
1	Aaa/Aa/A.....	\$5,103.8	\$ 5,186.8	46%	\$ 5,155.9	\$ 5,213.9	45%
2	Baa.....	4,476.7	4,570.6	40	4,749.2	4,822.0	42
3	Ba.....	1,176.2	1,173.7	10	1,151.3	1,126.5	10
4	B.....	304.6	295.8	3	349.5	335.4	3
5	Caa and lower.....	63.6	32.9	--	73.3	40.7	--
6	In or near default.....	125.7	96.6	1	111.0	72.9	--
Total public fixed maturities.....		\$11,250.6	\$11,356.4	100%	\$11,590.2	\$11,611.4	100%
		=====	=====	===	=====	=====	===

NAIC RATING	AS OF DECEMBER 31, 1999			AS OF DECEMBER 31, 1998			
	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	
-----							
(\$ IN MILLIONS)							
1	\$ 5,775.8	\$ 5,652.9	44%	\$ 5,525.4	\$ 5,837.6	42%	
2	5,648.6	5,561.8	43	5,968.2	6,285.9	46	
3	1,403.7	1,355.9	10	1,174.9	1,215.7	9	
4	223.9	210.7	2	251.6	249.8	2	
5	112.4	110.0	1	9.3	9.2	--	
6	81.1	60.2	--	105.5	76.7	1	
		\$13,245.5	\$12,951.5	100%	\$13,034.9	\$13,674.9	100%
		=====	=====	===	=====	=====	===

U.S. INVESTED ASSETS  
TOTAL FIXED MATURITY SECURITIES BY CREDIT QUALITY

NAIC RATING	RATING AGENCY EQUIVALENT	AS OF JUNE 30, 2001			AS OF DECEMBER 31, 2000		
		AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT
-----							
(\$ IN MILLIONS)							
1	Aaa/Aa/A.....	\$15,017.0	\$15,425.5	54%	\$14,185.3	\$14,496.9	56%
2	Baa.....	10,448.2	10,674.1	38	9,181.5	9,314.8	36
3	Ba.....	1,820.4	1,788.8	6	1,603.0	1,560.6	6
4	B.....	388.0	379.2	1	393.9	357.3	2
5	Caa and lower.....	158.5	111.2	--	101.0	68.0	--
6	In or near default.....	174.1	125.2	1	125.9	77.4	--
-----							
	Total public fixed maturities.....	\$28,006.2	\$28,504.0	100%	\$25,590.6	\$25,875.0	100%
		=====	=====	===	=====	=====	===

NAIC RATING	AS OF DECEMBER 31, 1999			AS OF DECEMBER 31, 1998		
	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	% OF TOTAL CARRYING AMOUNT
-----						
(\$ IN MILLIONS)						
1	\$12,767.7	\$12,541.3	56%	\$11,576.8	\$12,131.9	55%
2	8,106.9	7,986.6	35	7,392.1	7,777.6	36
3	1,638.4	1,588.9	7	1,500.1	1,560.9	7
4	259.6	246.7	1	258.4	256.3	1
5	139.8	138.3	1	24.2	13.0	--
6	139.1	82.5	--	156.4	92.8	1
-----						
	\$23,051.5	\$22,584.3	100%	\$20,908.0	\$21,832.5	100%
		=====	===	=====	=====	===

We believe that our long-term fixed maturity securities portfolio is well diversified among industry types and between publicly traded and privately placed securities. Each year we direct the majority of our net cash inflows into investment grade fixed maturity securities. We typically invest up to 7% of general account cash flow in below investment grade assets. While the general account investment returns have improved due to the below investment grade asset class, we manage its growth strategically by limiting it to 10% of the total fixed maturity securities portfolio.

We invest in privately placed fixed maturity securities to enhance the overall value of the portfolio, increase diversification and obtain higher yields than are possible with comparable quality public market securities. Generally, private placements provide broader access to management information, strengthened negotiated protective covenants, call protection features and, where applicable, a higher level of collateral. They are, however, generally not freely tradable because of restrictions imposed by federal and state securities laws and illiquid trading markets. As of June 30, 2001, the percentage, based on estimated fair value, of total publicly traded and privately placed fixed maturity securities that were investment grade with an NAIC Designation 1 or 2 was 92%.

The tables below show the carrying amount of our corporate fixed maturity securities by industry category, as well as the percentage of the total corporate portfolio that each industry category comprises as of June 30, 2001, and December 31, 2000, 1999, and 1998. The tables also show by industry category the relative amounts of publicly traded and privately placed securities.

U.S. INVESTED ASSETS

CORPORATE FIXED MATURITY SECURITIES PORTFOLIO BY INDUSTRY AS OF JUNE 30, 2001

INDUSTRY CLASS	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)					
Transportation and Public Utilities.....	\$ 4,820.2	41%	\$1,934.1	20%	\$ 6,754.3	32%
Finance, Insurance and Real Estate.....	3,066.7	26	2,305.1	24	5,371.8	25
Manufacturing.....	2,161.0	19	2,684.1	28	4,845.1	23
Mining.....	673.3	6	908.4	10	1,581.7	7
Retail.....	440.6	4	735.2	8	1,175.8	6
Services.....	403.7	4	671.6	7	1,075.3	5
Public Administration.....	34.9	--	86.0	1	120.9	1
Agriculture, Forestry and Fishing.....	19.6	--	48.9	1	68.5	--
Construction.....	1.3	--	112.0	1	113.3	1
Total.....	\$11,621.3	100%	\$9,485.4	100%	\$21,106.7	100%

U.S. INVESTED ASSETS

CORPORATE FIXED MATURITY SECURITIES PORTFOLIO BY INDUSTRY AS OF DECEMBER 31, 2000

INDUSTRY CLASS	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)					
Transportation and Public Utilities.....	\$3,197.1	37%	\$1,957.9	20%	\$ 5,155.0	28%
Finance, Insurance and Real Estate.....	2,657.1	30	2,300.9	24	4,958.0	27
Manufacturing.....	1,678.9	19	2,845.9	29	4,524.8	24
Mining.....	496.1	6	936.8	10	1,432.9	8
Services.....	351.5	4	686.3	7	1,037.8	5
Retail.....	295.2	3	795.9	8	1,091.1	6
Agriculture, Forestry and Fishing.....	34.7	1	41.2	--	75.9	--
Public Administration.....	20.3	--	111.4	1	131.7	1
Construction.....	9.9	--	120.3	1	130.2	1
Total.....	\$8,740.8	100%	\$9,796.6	100%	\$18,537.4	100%

U.S. INVESTED ASSETS  
CORPORATE FIXED MATURITY SECURITIES PORTFOLIO BY INDUSTRY AS OF DECEMBER 31,  
1999

INDUSTRY CLASS	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)					
Finance, Insurance and Real Estate.....	\$2,178.0	43%	\$ 2,426.8	22%	\$ 4,604.8	28%
Manufacturing.....	1,280.3	25	3,793.4	34	5,073.7	31
Transportation and Public Utilities.....	655.1	13	2,033.0	18	2,688.1	16
Services.....	374.2	7	803.6	7	1,177.8	7
Mining.....	296.3	6	963.9	9	1,260.2	8
Retail.....	247.8	5	923.9	8	1,171.7	7
Agriculture, Forestry and Fishing.....	60.1	1	42.6	--	102.7	1
Public Administration.....	9.6	--	70.0	1	79.6	1
Construction.....	2.9	--	160.8	1	163.7	1
<b>Total.....</b>	<b>\$5,104.3</b>	<b>100%</b>	<b>\$11,218.0</b>	<b>100%</b>	<b>\$16,322.3</b>	<b>100%</b>

U.S. INVESTED ASSETS  
CORPORATE FIXED MATURITY SECURITIES PORTFOLIO BY INDUSTRY AS OF DECEMBER 31,  
1998

INDUSTRY CLASS	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)					
Finance, Insurance and Real Estate.....	\$1,713.6	44%	\$ 2,241.1	18%	\$ 3,954.7	25%
Manufacturing.....	1,131.3	29	4,582.8	38	5,714.1	36
Transportation and Public Utilities.....	459.6	12	2,245.0	18	2,704.6	17
Retail.....	244.1	6	944.7	8	1,188.8	7
Mining.....	221.8	6	953.0	8	1,174.8	7
Services.....	100.2	2	788.4	7	888.6	6
Public Administration.....	35.9	1	127.7	1	163.6	1
Construction.....	18.6	--	142.6	1	161.2	1
Agriculture, Forestry and Fishing.....	--	--	60.4	1	60.4	--
<b>Total.....</b>	<b>\$3,925.1</b>	<b>100%</b>	<b>\$12,085.7</b>	<b>100%</b>	<b>\$16,010.8</b>	<b>100%</b>

As of June 30, 2001, our largest unaffiliated single concentration of fixed maturity securities consisted of \$358.1 million of corporate bonds by Ford Motor Company and its affiliates. This represented approximately 1% of our total U.S. invested assets as of June 30, 2001. No other individual non-government issuer represented more than 1% of U.S. invested assets.

We held \$6,450.7 million of mortgage-backed and asset-backed securities as of June 30, 2001, and \$6,416.3 million, \$5,442.8 million and \$5,078.8 million as of December 31, 2000, 1999 and 1998, respectively. The table below presents the types of mortgage-backed securities ("MBSs"), as well as other asset-backed securities, held as of the dates indicated:

U.S. INVESTED ASSETS  
MORTGAGE AND ASSET-BACKED SECURITIES

	CARRYING AMOUNT AS OF JUNE 30,	CARRYING AMOUNT AS OF DECEMBER 31,		
	2001	2000	1999	1998
	(\$ IN MILLIONS)			
Residential pass-through securities.....	\$3,285.1	\$3,426.5	\$2,971.6	\$2,968.8
Commercial MBS.....	1,692.5	1,403.4	969.4	677.4
Asset-backed securities.....	1,473.1	1,586.4	1,501.8	1,432.6
<b>Total MBSs and asset-backed securities.....</b>	<b>\$6,450.7</b>	<b>\$6,416.3</b>	<b>\$5,442.8</b>	<b>\$5,078.8</b>

We believe that it is desirable to hold residential mortgage-backed securities due to their credit quality and liquidity as well as portfolio diversification characteristics. Our portfolio is comprised of GNMA, FNMA and FHLMC pass-through securities and is actively managed to ensure that the securities held are trading close to or below par, in order to reduce risk of prepayments. As of June 30, 2001, we held no collateralized mortgage obligations in our U.S. invested asset portfolio.

Commercial mortgage-backed securities provide high levels of credit protection, diversification, reduced event risk and enhanced liquidity. Commercial mortgage-backed securities are predominantly comprised of rated large pool securitizations that are individually and collectively diverse by property type, borrower and geographic dispersion.

We purchase asset-backed securities, or ABS, to diversify the overall credit risks of the fixed maturity securities portfolio and to provide attractive returns. The principal risks in holding asset-backed securities are structural and credit risks. Structural risks include the security's priority in the issuer's capital structure, the adequacy of and ability to realize proceeds from the collateral and the potential for prepayments. Credit risks involve issuer/servicer risk where collateral values can become impaired in the event of servicer credit deterioration.

Our ABS portfolio is diversified both by type of asset and by issuer. We actively monitor holdings of asset-backed securities to ensure that the risk profile of each security improves or remains consistent. If we are not receiving an adequate yield for the risk, relative to other investment opportunities, we will attempt to sell the security. Prepayments in the ABS portfolio are, in general, insensitive to changes in interest rates or are insulated to such changes by call protection features. In the event that we are subject to prepayment risk, we monitor the factors that impact the level of prepayment and prepayment speed for those asset-backed securities. To the extent we believe that prepayment risk increases, we may attempt to sell the security and reinvest in another security that offers better yield relative to the risk. In addition, we diversify the risks of asset-backed securities by holding a diverse class of securities, which limits our exposure to any one security.

U.S. INVESTED ASSETS  
ASSET-BACKED SECURITIES BY TYPE

	CARRYING AMOUNT AS OF JUNE 30,	CARRYING AMOUNT AS OF DECEMBER 31,		
	2001	2000	1999	1998
		----- (\$ IN MILLIONS) -----		
Credit cards.....	\$ 180.8	\$ 220.0	\$ 260.9	\$ 115.1
Automobile receivables.....	62.9	72.2	81.0	46.1
Collateralized debt obligations.....	570.1	579.1	654.2	545.8
Lease receivables.....	162.1	198.9	289.1	402.4
Consumer loans.....	134.7	145.0	168.5	42.9
Other.....	362.5	371.2	48.1	280.3
	-----	-----	-----	-----
Total asset-backed securities.....	\$1,473.1	\$1,586.4	\$1,501.8	\$1,432.6
	=====	=====	=====	=====

In accordance with our asset liability risk management techniques, we manage the expected lives of U.S. invested assets to be similar to the lives of our liabilities. Significant amounts of our liabilities have an expected life of six years or less. Therefore, comparable amounts of assets have a similar expected life. The amortized cost and estimated fair value of fixed maturity securities, by contractual maturity dates, excluding scheduled sinking funds, as of June 30, 2001, and as of December 31, 2000 and 1999, respectively is as follows:

U.S. INVESTED ASSETS  
FIXED MATURITY SECURITIES BY CONTRACTUAL MATURITY DATES

	AS OF JUNE 30,		AS OF DECEMBER 31,			
	2001		2000		1999	
	AMORTIZED COST	CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT
	(\$ IN MILLIONS)					
Due in one year or less.....	\$ 1,269.8	\$ 1,272.8	\$ 1,093.6	\$ 1,083.8	\$ 1,263.5	\$ 1,261.6
Due after one year through five years...	10,435.4	10,593.0	9,691.0	9,687.7	8,263.0	8,130.0
Due after five years through ten years.....	5,686.1	5,793.7	5,058.0	5,135.6	4,908.4	4,820.6
Due after ten years.....	4,297.8	4,393.8	3,505.4	3,551.6	3,056.4	2,929.3
Subtotal.....	21,689.1	22,053.3	19,348.0	19,458.7	17,491.3	17,141.5
Mortgage-backed and other securities without a single maturity date.....	6,317.1	6,450.7	6,242.6	6,416.3	5,560.2	5,442.8
Total.....	\$28,006.2	\$28,504.0	\$25,590.6	\$25,875.0	\$23,051.5	\$22,584.3

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

The table below presents the total carrying amount of our fixed maturity portfolio, as well as its problem, potential problem and restructured fixed maturities:

U.S. INVESTED ASSETS  
PROBLEM, POTENTIAL PROBLEM AND RESTRUCTURED FIXED MATURITIES AT CARRYING AMOUNT

	AS OF JUNE 30,	AS OF DECEMBER 31,		
	2001	2000	1999	1998
	(\$ IN MILLIONS)			
Total fixed maturity securities (public and private).....	\$28,504.0	\$25,875.0	\$22,584.3	\$21,832.5
Problem fixed maturity securities.....	\$ 137.5	\$ 79.0	\$ 85.1	\$ 92.5
Potential problem fixed maturity securities.....	140.0	132.5	150.1	76.5
Restructured fixed maturity securities.....	68.4	48.6	27.6	73.5
Total problem, potential problem and restructured fixed maturity securities.....	\$ 345.9	\$ 260.1	\$ 262.8	\$ 242.5
Total problem, potential problem and restructured fixed maturity securities as a percent of total fixed maturity securities.....	1%	1%	1%	1%

EQUITY SECURITIES

Our equity securities consist primarily of investments in common stocks. We classify our investment in common stocks as available for sale and report them at estimated fair value. We report unrealized gains and losses on common

stocks as a separate component of other comprehensive income, net of deferred income taxes and an adjustment for the effect on deferred acquisition costs that would have occurred if such gains and losses had been realized.

Investments in equity securities totaled \$539.4 million, which represented 1% of U.S. invested assets as of June 30, 2001 and \$666.0 million, \$768.1 million and \$995.7 million, which represented 2% of U.S. invested assets as of December 31, 2000, 1999 and 1998, respectively. Investments in company-sponsored funds totaled \$503.2 million, or 93%, of our U.S. equity securities as of June 30, 2001. These sponsored funds are intended to be marketed to our asset management clients. Of company-sponsored funds, \$357.3 million represented underlying investments in publicly-traded equities, \$140.0 million represented investments in publicly-traded fixed income securities and \$5.9 million in balanced funds which represented investments in both publicly-traded equities and fixed income securities as of June 30, 2001. The remaining balance of equity securities is a mixture of public and private securities acquired for investment purposes or which were acquired through equity participation features of below investment grade bonds or through recoveries of defaulted securities. Beginning in 1996, we repositioned our investment portfolio by selling invested assets with lower yields, primarily equities and real estate, and reinvesting the proceeds in assets with higher yields, primarily debt securities.

#### MORTGAGE LOANS

Mortgage loans comprised 26% of total U.S. invested assets as of June 30, 2001, 27% as of December 31, 2000 and 33% at each of December 31, 1999 and 1998. Mortgage loans consist of commercial and residential loans. As of June 30, 2001 and December 31, 2000, 1999 and 1998, commercial mortgage loans comprised \$10,340.7 million, \$10,775.3 million, \$12,588.9 million and \$12,157.2 million, or 91%, 95%, 95% and 92%, of total mortgage loan investments, respectively. Residential mortgages comprised \$1,023.3 million, \$550.5 million, \$651.0 million and \$997.4 million, or 9%, 5%, 5% and 8%, of total mortgage loan investments as of June 30, 2001 and December 31, 2000, 1999 and 1998, respectively. Principal Residential Mortgage, Inc. and Principal Bank hold the majority of residential loans. Principal Residential Mortgage, Inc. holds residential loans as part of its securitization inventory and Principal Bank holds residential loans to comply with federal thrift charter requirements.

On September 30, 2000, we completed a securitization of \$598.0 million of general account commercial loans comprised of 102 loans. We sold \$578.4 million of investment grade bonds into the market and we retained \$28.7 million of interest only bonds.

COMMERCIAL MORTGAGE LOANS. Commercial mortgages play an important role in our investment strategy by:

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

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

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

California accounted for 22% of our commercial mortgage loan portfolio as of June 30, 2001. We are, therefore, exposed to potential losses resulting from the risk of catastrophes, such as earthquakes, that may affect the region. Like other lenders, we generally do not require earthquake insurance for properties on which we make commercial mortgage loans. With respect to California properties, however, we obtain an engineering report specific to each property. The report assesses the building's design specifications, whether it has been upgraded to meet seismic building codes and the maximum loss that is likely to result from a variety of different seismic events. We also obtain a report that assesses by building and geographic fault lines the amount of loss our commercial mortgage loan portfolio might suffer under a variety of seismic events.



The following is a summary of our commercial mortgage loans by property type and geographic area as of June 30, 2001, and December 31, 2000, 1999 and 1998, respectively:

U.S. INVESTED ASSETS  
COMMERCIAL MORTGAGE LOAN DISTRIBUTION BY TYPE

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)							
Retail.....	\$ 3,370.1	32%	\$ 3,612.7	34%	\$ 4,194.7	33%	\$ 4,082.8	33%
Office.....	3,305.0	32	3,273.5	30	3,841.0	31	3,500.8	29
Industrial.....	3,197.0	31	3,381.6	31	4,048.3	32	4,050.5	33
Apartments.....	373.0	4	419.7	4	423.9	3	348.2	3
Mixed Use/other.....	118.0	1	130.2	1	127.8	1	199.4	2
Hotel.....	63.6	1	65.6	1	71.0	1	88.5	1
Valuation allowance.....	(86.0)	(1)	(108.0)	(1)	(117.8)	(1)	(113.0)	(1)
Total.....	\$10,340.7	100%	\$10,775.3	100%	\$12,588.9	100%	\$12,157.2	100%

U.S. INVESTED ASSETS  
COMMERCIAL MORTGAGE LOAN DISTRIBUTION BY REGION

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)							
Region:								
Pacific.....	\$ 2,650.8	26%	\$ 2,774.8	26%	\$ 3,410.2	27%	\$ 3,371.8	28%
South Atlantic.....	2,476.7	24	2,630.5	24	3,175.2	25	3,024.9	25
Middle Atlantic.....	1,643.5	16	1,664.9	15	1,775.2	14	1,687.6	14
East North Central.....	1,048.0	10	1,006.2	9	1,235.4	10	1,222.1	10
West South Central.....	848.8	8	886.4	8	904.9	7	810.9	7
Mountain.....	614.2	6	600.2	6	643.5	5	553.9	4
West North Central.....	422.6	4	439.9	4	535.1	5	579.3	5
New England.....	377.4	4	495.9	5	598.7	5	616.0	5
East South Central.....	344.7	3	384.5	4	428.5	3	403.7	3
Valuation allowance.....	(86.0)	(1)	(108.0)	(1)	(117.8)	(1)	(113.0)	(1)
Total.....	\$10,340.7	100%	\$10,775.3	100%	\$12,588.9	100%	\$12,157.2	100%

Our commercial loan portfolio is highly diversified by borrower. As of June 30, 2001, 44% of the U.S. commercial mortgage loan portfolio was comprised of mortgage loans with principal balances of less than \$10 million. The table below shows our U.S. commercial mortgage loan portfolio by loan size, as of the periods indicated:

U.S. INVESTED ASSETS  
COMMERCIAL MORTGAGE LOAN PORTFOLIO -- BY LOAN SIZE

	AS OF JUNE 30,			AS OF DECEMBER 31,					
	2001			2000			1999		
	NUMBER OF LOANS	PRINCIPAL BALANCE	% OF TOTAL	NUMBER OF LOANS	PRINCIPAL BALANCE	% OF TOTAL	NUMBER OF LOANS	PRINCIPAL BALANCE	% OF TOTAL
	(\$ IN MILLIONS)								
Under \$5 million.....	1,208	\$ 2,548.0	24%	1,236	\$ 2,553.5	24%	1,451	\$ 3,110.8	
\$5 million but less than \$10 million.....	303	2,119.2	20	304	2,116.5	19	380	2,622.6	
\$10 million but less than \$20 million.....	174	2,322.1	22	187	2,515.2	23	204	2,733.2	
\$20 million but less than \$30 million.....	60	1,410.7	14	63	1,495.3	14	67	1,617.6	
\$30 million and over.....	46	2,045.5	20	48	2,204.5	20	56	2,640.2	
Total.....	1,791	\$10,445.5	100%	1,838	\$10,885.0	100%	2,158	\$12,724.4	

  

AS OF DECEMBER 31,			
1999		1998	
% OF	NUMBER	PRINCIPAL	% OF

	TOTAL	OF LOANS	BALANCE	TOTAL
	(\$ IN MILLIONS)			
Under \$5 million.....	24%	1,515	\$ 3,179.2	26%
\$5 million but less than \$10 million.....	21	384	2,649.9	22
\$10 million but less than \$20 million.....	21	204	2,776.2	23
\$20 million but less than \$30 million.....	13	58	1,408.4	11
\$30 million and over.....	21	47	2,257.2	18
	---	---	---	---
Total.....	100%	2,208	\$12,270.9	100%
	===	=====	=====	===

The total number of commercial mortgage loans outstanding as of June 30, 2001 and December 31, 2000, 1999 and 1998, was 1,791, 1,838, 2,158 and 2,208, respectively. The average loan size of our commercial mortgage portfolio

was \$5.8 million as of June 30, 2001, \$5.9 million as of December 31, 2000 and 1999, and \$5.6 million as of December 31, 1998. The largest loan on any single property at such dates aggregated \$100.0 million for June 30, 2001 and December 31, 2000, 1999 and 1998, respectively, and represented 0.2% of U.S. invested assets on these dates. Total mortgage loans to the 10 largest borrowers accounted in the aggregate for approximately 7% of the total carrying amount of the commercial mortgage loan portfolio as of June 30, 2001 and December 31, 2000 and 6% as of December 31, 1999 and 1998, respectively, and 2% of total U.S. invested assets as of June 30, 2001, and December 31, 2000, 1999 and 1998, respectively. As of such dates, all such loans were performing.

The table below presents the disposition of maturities for the six months ended June 30, 2001, and for the years ended December 31, 2000, 1999 and 1998:

U.S. INVESTED ASSETS  
DISPOSITIONS OF SCHEDULED MATURITIES OF COMMERCIAL MORTGAGE LOANS

	AS OF	AS OF DECEMBER 31,		
	JUNE 30,	2000	1999	1998
	2001	2000	1999	1998
	AMORTIZED	AMORTIZED	AMORTIZED	AMORTIZED
	COST	COST	COST	COST
	-----	-----	-----	-----
	(\$ IN MILLIONS)			
Paid as scheduled.....	\$143.6	\$395.0	\$401.9	\$300.0
Extended.....	179.2	174.8	164.9	361.0
Refinanced.....	19.4	82.7	204.4	203.9
Foreclosed.....	5.5	--	--	8.0
Expired maturities.....	--	59.1	--	35.1
	-----	-----	-----	-----
Total.....	\$347.7	\$711.6	\$771.2	\$908.0
	=====	=====	=====	=====

The amortized cost of commercial mortgage loans by contractual maturity dates, excluding scheduled sinking funds as of June 30, 2001, and December 31, 2000, 1999 and 1998, respectively, are as follows:

U.S. INVESTED ASSETS  
COMMERCIAL MORTGAGE LOAN PORTFOLIO MATURITY PROFILE

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	AMORTIZED	% OF	AMORTIZED	% OF	AMORTIZED	% OF	AMORTIZED	% OF
	COST	TOTAL	COST	TOTAL	COST	TOTAL	COST	TOTAL
	-----	-----	-----	-----	-----	-----	-----	-----
	(\$ IN MILLIONS)							
Due in one year or less.....	\$ 538.7	5%	\$ 675.8	6%	\$ 735.4	6%	\$ 806.3	7%
Due after one year through five years.....	3,445.0	33	3,033.4	28	3,045.0	24	2,629.2	21
Due after five years through ten years.....	3,278.4	32	3,900.7	36	4,862.1	38	4,711.1	38
Due after ten years.....	3,164.6	30	3,273.4	30	4,064.1	32	4,123.6	34
	-----	-----	-----	-----	-----	-----	-----	-----
Total.....	\$10,426.7	100%	\$10,883.3	100%	\$12,706.6	100%	\$12,270.2	100%
	=====	===	=====	===	=====	===	=====	===

We actively monitor and manage our commercial mortgage loan portfolio. Substantially all loans within the portfolio are analyzed regularly, based on a proprietary risk rating cash flow model, in order to monitor the financial quality of these assets and are internally rated. Based on ongoing monitoring, mortgage loans with a likelihood of becoming delinquent are identified and placed on an internal "watch list". Among criteria which would indicate a potential problem are: imbalances in ratios of loan to value or contract rents to debt service, major tenant vacancies or bankruptcies, borrower sponsorship problems, late payments, delinquent taxes and loan relief/restructuring requests.

We state commercial mortgage loans at their unpaid principal balances, net of discount accrual and premium amortization, valuation allowances and writedowns for impairment. We provide a valuation allowance for commercial mortgage loans based on past loan loss experience and for specific loans considered to be impaired. Mortgage loans are considered impaired when, based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement may not be collected. When we determine that a loan is impaired, we establish a valuation allowance for loss for the excess of the carrying value of the mortgage loan over its estimated fair value. Estimated fair value is based on either the present value of expected future cash flows discounted at the loan's original effective interest rate, the loan's observable market price or the fair value of the collateral. We record increases in such valuation allowances as realized investment losses and, accordingly, we reflect such losses in our consolidated



results of operations. Such increases (decreases) in valuation allowances aggregated \$(22.0) million as of June 30, 2001, and \$(9.8) million, \$4.8 million and \$(8.4) million for the years ended December 31, 2000, 1999 and 1998, respectively.

We review our mortgage loan portfolio and analyze the need for a valuation allowance for any loan which is delinquent for 60 days or more, in process of foreclosure, restructured, on the "watch list", or which currently has a valuation allowance. We categorize loans which are delinquent, loans in process of foreclosure and loans to borrowers in bankruptcy as "problem" loans. Potential problem loans are loans placed on an internal "watch list" for which management has concerns as to the ability of the borrower to comply with the present loan payment terms and which may result in the loan becoming a problem or being restructured. The decision whether to classify a performing loan as a potential problem involves significant subjective judgments by management as to the likely future economic conditions and developments with respect to the borrower. We categorize loans for which the original terms of the mortgages have been modified or for which interest or principal payments have been deferred as "restructured" loans. We also consider matured loans that are refinanced at below market rates as restructured.

We charge mortgage loans deemed to be uncollectible against the allowance for losses and credit subsequent recoveries to the allowance for losses. We maintain the allowance for losses at a level management believes to be adequate to absorb estimated probable credit losses. Management bases its periodic evaluation of the adequacy of the allowance for losses on our past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of the underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. The evaluation is inherently subjective as it requires estimating the amounts and timing of future cash flows expected to be received on impaired loans that may change.

The table below represents our commercial mortgage valuation allowance for the periods indicated:

U.S. INVESTED ASSETS  
COMMERCIAL MORTGAGE VALUATION ALLOWANCE

	AS OF JUNE 30,	AS OF DECEMBER 31,		
	2001	2000	1999	1998
(\$ IN MILLIONS)				
Beginning Balance.....	\$108.0	\$117.8	\$113.0	\$121.4
Provision.....	0.3	3.0	9.2	7.3
Release due to writedowns, sales and foreclosures.....	(22.3)	(12.8)	(4.4)	(15.7)
Ending Balance.....	\$ 86.0	\$108.0	\$117.8	\$113.0
Valuation allowance as a percentage of carrying value before reserves.....	1%	1%	1%	1%

The following table presents the carrying amounts of problem, potential problem and restructured commercial mortgages relative to the carrying amount of all commercial mortgages as of the dates indicated:

U.S. INVESTED ASSETS  
PROBLEM, POTENTIAL PROBLEM AND RESTRUCTURED COMMERCIAL MORTGAGES AT CARRYING AMOUNT

	AS OF JUNE 30,	AS OF DECEMBER 31,		
	2001	2000	1999	1998
(\$ IN MILLIONS)				
Total commercial mortgages.....	\$10,340.7	\$10,775.3	\$12,588.9	\$12,157.2
Problem commercial mortgages(1).....	\$ 22.6	\$ 8.9	\$ 38.7	\$ 73.4
Potential problem commercial mortgages.....	--	58.9	39.9	24.9
Restructured commercial mortgages.....	49.6	92.6	101.5	126.2
Total problem, potential problem and restructured commercial mortgages.....	\$ 72.2	\$ 160.4	\$ 180.1	\$ 224.5
Total problem, potential problem and restructured commercial mortgages as a percent of total commercial mortgages.....	1%	1%	1%	2%

(1) Problem commercial mortgages included mortgage loans in foreclosure of \$6.0 million, \$23.8 million and \$27.4 million as of December 31, 2000, 1999 and 1998, respectively. There were no mortgage loans in foreclosure as of June



The delinquency and loss performance of our U.S. invested loan portfolio has generally outperformed the life insurance industry averages as reported by the American Council Life Insurers. The table below presents mortgage loan delinquency rates for the industry and Principal Life on a statutory basis, expressed as a percentage of the total commercial loan portfolio at year end:

U.S. INVESTED ASSETS  
MORTGAGE LOAN DELINQUENCY(1)

	AS OF JUNE 30,		AS OF DECEMBER 31,								
	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991
Industry(2).....	0.2%	0.2%	0.3%	0.5%	0.9%	1.8%	2.4%	3.4%	4.5%	6.4%	5.9%
Principal Life.....	0.0	0.1	0.3	0.5	0.7	1.0	1.3	2.9	1.8	3.9	2.1

(1) Includes loans that are delinquent and in process of foreclosure. As defined by the American Council of Life Insurers, mortgage loans are classified as delinquent when they are 60 days or more past due as to the payment of interest or principal.

(2) As reported by the American Council of Life Insurers.

EQUITY REAL ESTATE

We hold commercial equity real estate as part of our investment portfolio. As of June 30, 2001 and December 31, 2000, 1999 and 1998, the carrying amount of equity real estate investment was \$1,230.3 million, \$1,391.8 million, \$2,201.2 million and \$2,585.2 million, respectively, or 3%, 4%, 6% and 7%, of U.S. invested assets. We own real estate, real estate acquired upon foreclosure of commercial mortgage loans and interests, both majority owned and non-majority owned, in real estate joint ventures. We continue to focus on a long-term strategy of reducing our real estate equity portfolio.

Equity real estate is categorized as either "real estate held for investment" or "real estate held for sale". Real estate held for investment totaled \$577.2 million as of June 30, 2001 and \$696.4 million, \$1,167.8 million and \$1,535.4 million as of December 31, 2000, 1999 and 1998, respectively. The carrying value of real estate held for investment is generally adjusted for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Such impairment adjustments are recorded as realized investment losses and accordingly, are reflected in our consolidated results of operations. For the six months ended June 30, 2001 and years ended December 31, 2000, 1999 and 1998, there were no such impairment adjustments.

The carrying amount of real estate held for sale as of June 30, 2001 and December 31, 2000, 1999 and 1998 was \$653.1 million, \$695.4 million, \$1,033.4 million and \$1,049.8 million, net of valuation allowances of \$34.2 million, \$40.8 million, \$70.4 million and \$33.1 million, respectively. Once we identify a real estate property to be sold and commence a plan for marketing the property, we classify the property as held for sale. We establish a valuation allowance subject to periodical revisions, if necessary, to adjust the carrying value of the property to reflect the lower of its current carrying value or the fair value, less associated selling costs.

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

Equity real estate is distributed across geographic regions of the country with larger concentrations in the South Atlantic, Pacific, and West South Central regions of the United States as of June 30, 2001. By property type, there is a concentration in office buildings that represented approximately 44% of the equity real estate portfolio as of June 30, 2001. Our largest equity real estate holding as of June 30, 2001 consisted of an office/industrial park located in Durham, North Carolina with an aggregate carrying value of approximately \$145.7 million and represented approximately 12% of total U.S. equity real estate assets and 0.3% of U.S. invested assets. The ten largest real estate properties as of June 30, 2001 comprised 50% of total U.S. equity real estate assets and 1% of total U.S. invested assets.

The tables below present information concerning the geographic and property type breakdown of the equity real estate portfolio as of June 30, 2001, and December 31, 2000, 1999 and 1998:

U.S. INVESTED ASSETS  
EQUITY REAL ESTATE BY REGION

	AS OF JUNE 30,		2000		AS OF DECEMBER 31,		1998	
	2001				1999			
	CARRYING AMOUNT	PERCENTAGE	CARRYING AMOUNT	PERCENTAGE	CARRYING AMOUNT	PERCENTAGE	CARRYING AMOUNT	PERCENTAGE
	(\$ IN MILLIONS)							
Region(1):								
South Atlantic.....	\$ 462.7	38%	\$ 431.7	31%	\$ 676.1	31%	\$ 714.8	28%
West South Central.....	288.4	23	362.2	26	449.2	20	486.7	19
Pacific.....	235.4	19	384.6	28	534.3	24	634.8	25
East North Central.....	133.9	11	120.7	9	152.0	7	150.2	6
East South Central.....	36.4	3	21.5	1	28.0	1	34.6	1
West North Central.....	28.2	2	19.0	1	119.2	6	115.3	4
Middle Atlantic.....	21.4	2	28.7	2	48.0	2	208.4	8
New England.....	14.3	1	14.5	1	112.5	5	142.4	5
Mountain.....	9.6	1	8.9	1	81.9	4	98.0	4
Total.....	\$1,230.3	100%	\$1,391.8	100%	\$2,201.2	100%	\$2,585.2	100%

(1) Regions are as defined by the American Council of Life Insurers.

U.S. INVESTED ASSETS  
EQUITY REAL ESTATE BY PROPERTY TYPE

	AS OF JUNE 30,		2000		AS OF DECEMBER 31,		1998	
	2001				1999			
	CARRYING AMOUNT	PERCENTAGE	CARRYING AMOUNT	PERCENTAGE	CARRYING AMOUNT	PERCENTAGE	CARRYING AMOUNT	PERCENTAGE
	(\$ IN MILLIONS)							
Office.....	\$ 538.5	44%	\$ 615.5	44%	\$ 721.7	33%	\$ 979.8	38%
Industrial.....	247.2	20	413.6	30	462.2	21	557.6	21
Retail.....	232.9	19	152.7	11	691.4	31	689.9	27
Service center.....	119.7	10	120.1	9	205.6	9	308.1	12
Land.....	57.9	4	89.9	6	120.3	6	49.8	2
Apartments.....	34.1	3	--	--	--	--	--	--
Total.....	\$1,230.3	100%	\$1,391.8	100%	\$2,201.2	100%	\$2,585.2	100%

DERIVATIVES

We use various derivative financial instruments to manage our exposure to fluctuations in interest rates, including interest rate futures and interest rate swaps and swaptions. We use interest rate futures contracts to hedge changes in interest rates subsequent to the issuance of an insurance liability, such as a guaranteed investment contract, but prior to the purchase of a supporting asset, or during periods of holding assets in anticipation of near term liability sales. We use interest rate swaps primarily to more closely match the interest rate characteristics of assets and liabilities. They can be used to change the interest rate characteristics of specific assets and liabilities as well as an entire portfolio. Occasionally, we will sell a callable liability or a liability with attributes similar to a call option. In these cases, we will use interest rate swaptions or similar products to hedge the risk of early liability payment, thereby transforming the callable liability into a fixed term liability.

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

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from our international operations and foreign currency-denominated funding agreements issued to non-qualified institutional investors in the international market. The notional amount of our





currency swap agreements associated with foreign-denominated liabilities as of June 30, 2001 was \$3,078.5 million. We also have fixed maturity securities that are denominated in foreign currencies. However, we use derivatives to hedge the foreign currency risk of these funding agreements and securities. As of June 30, 2001, the fair value of our foreign currency denominated fixed maturity securities was \$381.8 million. We use currency swap agreements of the same currency to hedge the foreign currency exchange risk related to these investments. The notional amount of our currency swap agreements associated with foreign-denominated fixed maturity securities as of June 30, 2001 was \$398.5 million.

In conjunction with the interest rate swaps, interest rate swaptions and other derivatives, we are exposed to counterparty risk, or the risk that counterparty fails to perform the terms of the derivative contract. We actively manage this risk by:

- establishing exposure limits which take into account non-derivative exposure we have with the counterparty as well as derivative exposure;
- performing similar credit analysis prior to approval on each derivatives counterparty that we do when lending money on a long-term basis;
- limiting exposure to AA- credit or better;
- conducting stress-test analysis to determine the maximum exposure created during the life of a prospective transaction; and
- daily monitoring of counterparty credit ratings.

All new derivative counterparties are approved by the investment committee. We believe the risk of incurring losses due to nonperformance by our counterparties is remote and that such losses, if any, would not be material. Futures contracts trade on organized exchanges and, therefore, effectively have no credit risk.

The notional amounts used to express the extent of our involvement in swap transactions represent a standard measurement of the volume of our swap business. Notional amount is not a quantification of market risk or credit risk and it may not necessarily be recorded on the balance sheet. Notional amounts represent those amounts used to calculate contractual flows to be exchanged and are not paid or received, except for contracts such as currency swaps. Actual credit exposure represents the amount owed to us under derivative contracts as of the valuation date.

The following tables present our position in, and credit exposure to, derivative financial instruments as of June 30, 2001, and December 31, 2000, 1999 and 1998, respectively:

U.S. INVESTED ASSETS  
DERIVATIVE FINANCIAL INSTRUMENTS

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	NOTIONAL AMOUNT	% OF TOTAL	NOTIONAL AMOUNT	% OF TOTAL	NOTIONAL AMOUNT	% OF TOTAL	NOTIONAL AMOUNT	% OF TOTAL
(\$ IN MILLIONS)								
Foreign currency swaps.....	\$ 3,477.0	16%	\$ 2,745.0	26%	\$ 1,571.5	15%	\$ 485.9	4%
Interest rate floors.....	3,200.0	15	2,450.0	23	5,550.0	52	5,250.0	46
Interest rate swaps.....	3,243.2	15	2,391.5	23	1,298.5	12	1,533.0	13
Mortgage-backed forwards and options.....	9,770.5	44	1,898.3	18	1,546.7	14	81.5	1
Swaptions.....	1,815.0	8	697.7	7	469.7	4	259.0	2
Call options.....	30.0	--	30.0	--	30.0	--	30.0	--
Put options.....	--	--	--	--	--	--	18.0	--
Mandatory forwards, options and futures.....	--	--	--	--	--	--	2,369.0	21
U.S. Treasury futures.....	235.7	1	183.2	2	287.6	3	840.7	7
Currency forwards.....	39.4	--	39.4	--	13.0	--	--	--
Options on futures contract.....	--	--	--	--	--	--	681.7	6
Principal Only swaps.....	250.0	1	--	--	--	--	--	--
Treasury rate guarantees.....	61.0	--	60.0	1	--	--	--	--
Total.....	\$22,121.8	100%	\$10,495.1	100%	\$10,767.0	100%	\$11,548.8	100%

U.S. INVESTED ASSETS  
DERIVATIVE FINANCIAL INSTRUMENTS

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CREDIT EXPOSURE	% OF TOTAL	CREDIT EXPOSURE	% OF TOTAL	CREDIT EXPOSURE	% OF TOTAL	CREDIT EXPOSURE	% OF TOTAL
	(\$ IN MILLIONS)							
Foreign currency swaps.....	\$ 25.1	5%	\$ 45.3	42%	\$ 69.2	50%	\$ 35.2	54%
Interest rate floors.....	5.7	1	20.0	18	15.1	11	5.9	9
Interest rate swaps.....	30.3	7	14.1	13	21.6	15	18.6	28
Call options.....	10.0	2	12.3	11	19.0	14	--	--
Swaptions.....	11.9	3	11.8	11	8.7	6	5.6	9
Put options.....	--	--	--	--	--	--	0.3	--
Currency forwards.....	8.7	2	5.5	5	--	--	--	--
Mortgage-backed forwards and options.....	359.8	80	--	--	6.0	4	--	--
Total.....	\$451.5	100%	\$109.0	100%	\$139.6	100%	\$65.6	100%
	=====	===	=====	===	=====	===	=====	===

OTHER INVESTMENTS

Our other investments totaled \$786.9 million as of June 30, 2001, compared to \$681.2 million as of December 31, 2000 and \$514.0 million as of December 31, 1999. Our investment in Coventry is included in other investments as we accounted for it using the equity method. As of June 30, 2001, our carrying value in Coventry was \$134.6 million. Also included in other investments is a \$135.2 million investment in an Australian hotel trust, which we acquired in connection with our acquisition of BT Financial Group. With the adoption of SFAS 133 on January 1, 2001, derivatives were reflected on our balance sheet and accounted for \$116.4 million in other investments as of June 30, 2001. The remaining investment assets include leases and other private equity investments.

SECURITIES LENDING

The terms of our securities lending program, approved in 1999, allow us to lend our securities to major brokerage firms. Our policy requires an initial minimum of 102% of the fair value of the loaned securities as collateral. Although we lend from time to time during the financial reporting quarters, we had no securities on loan as of December 31, 2000 and December 31, 1999. Our securities on loan as of June 30, 2001, had a fair value of \$345.2 million.

INTERNATIONAL INVESTMENT OPERATIONS

As of June 30, 2001, our international investment operations consist of the investments of Principal International and BT Financial Group and comprise \$1.2 billion in invested assets, which primarily represent the assets of Principal International. Principal Capital Management works with each Principal International affiliate to develop investment policies and strategies that are consistent with the products they offer. Due to the regulatory constraints in each country, each company maintains its own investment policies which are approved by Principal Capital Management. Each international affiliate is required to submit a compliance report relative to its strategy to Principal Capital Management. A credit committee comprised of Principal Capital Management employees and international affiliate company chief investment officer's review each corporate credit annually. In addition, employees from our U.S. operations who serve on the credit committee currently hold investment positions in two of our international affiliates. Principal Capital Management provides annual credit approval training to Principal International personnel.

OVERALL COMPOSITION OF INTERNATIONAL INVESTED ASSETS

As shown in the table below, the major categories of international invested assets as of June 30, 2001, were fixed maturity securities and residential mortgage loans:

INTERNATIONAL INVESTED ASSETS

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
(\$ IN MILLIONS)								
Fixed maturity securities, available for sale								
Public.....	\$ 809.0	70%	\$ 948.6	70%	\$ 857.0	68%	\$ 653.1	64%
Private.....	15.2	1	16.3	1	2.6	--	242.4	24
Equity securities, available for sale.....	39.4	3	76.9	6	96.1	8	106.6	11
Mortgage loans								
Residential.....	175.1	15	166.9	12	92.3	7	--	--
Real estate held for investment.....	8.0	1	8.7	1	10.8	1	--	--
Other investments.....	111.8	10	129.8	10	196.4	16	10.6	1
Total invested assets.....	\$1,158.5	100%	\$1,347.2	100%	\$1,255.2	100%	\$1,012.7	100%
Cash and cash equivalents.....	134.8		176.5		201.1		44.6	
Total invested assets and cash.....	\$1,293.3		\$1,523.7		\$1,456.3		\$1,057.3	

INTERNATIONAL INVESTMENT RESULTS

The yield on international invested assets, excluding net realized gains and losses, was 8.6% as of June 30, 2001 and 7.1%, 7.5% and 6.2% for the years ended December 31, 2000, 1999 and 1998, respectively.

The table below illustrates the yields on average assets for each of the components of our investment portfolio for the six months ended June 30, 2001, and for the years ended December 31, 2000, 1999 and 1998:

INTERNATIONAL INVESTED ASSETS  
YIELDS BY ASSET TYPE

	AS OF JUNE 30,		AS OF OR FOR THE YEAR ENDED DECEMBER 31,					
	2001		2000		1999		1998	
	YIELD	AMOUNT	YIELD	AMOUNT	YIELD	AMOUNT	YIELD	AMOUNT
	(\$ IN MILLIONS)							
Fixed maturity securities, available-for-sale								
Gross investment income(1)	9.5%	\$ 42.4	7.4%	\$ 67.4	6.9%	\$ 61.0	6.6%	\$ 41.5
Net realized capital gains (losses)	(0.2)	(1.1)	0.4	3.7	0.8	7.4	(0.1)	(0.9)
Total		\$ 41.3		\$ 71.1		\$ 68.4		\$ 40.6
Ending assets (at carrying value)		\$824.2		\$964.9		\$859.6		\$895.5
Equity securities, available-for-sale								
Gross investment income(1)	--%	\$ --	0.6%	\$ 0.5	6.9%	\$ 7.0	1.4%	\$ 1.1
Net realized capital gains (losses)	2.4	0.7	(1.3)	(1.1)	1.6	1.6	0.3	0.2
Total		\$ 0.7		\$ (0.6)		\$ 8.6		\$ 1.3
Ending assets (at carrying value)		\$ 39.4		\$ 76.9		\$ 96.1		\$106.6
Mortgage loans -- Residential								
Gross investment income(1)	10.8%	\$ 9.2	8.6%	\$ 11.2	15.2%	\$ 7.0	--%	\$ --
Net realized capital gains (losses)	--	--	--	--	--	--	--	--
Total		\$ 9.2		\$ 11.2		\$ 7.0		\$ --
Ending assets (at carrying value)		\$175.1		\$166.9		\$ 92.3		\$ --
Real estate								
Gross investment income(1)	9.6%	\$ 0.4	5.1%	\$ 0.5	8.6%	\$ 0.4	--%	\$ --
Net realized capital gains (losses)	--	--	--	--	--	--	--	--
Total		\$ 0.4		\$ 0.5		\$ 0.4		\$ --
Ending assets (at carrying value)		\$ 8.0		\$ 8.7		\$ 10.8		\$ --
Cash and cash equivalents								
Gross investment income(1)	4.5%	\$ 3.5	4.4%	\$ 8.3	4.8%	\$ 5.9	8.7%	\$ 3.7
Net realized capital gains (losses)	--	--	--	--	--	--	(0.2)	(0.1)
Total		\$ 3.5		\$ 8.3		\$ 5.9		\$ 3.6
Ending assets (at carrying value)		\$134.8		\$176.5		\$201.1		\$ 44.6
Other investments								
Gross investment income(1)	9.6%	\$ 5.8	11.7%	\$ 19.1	15.4%	\$ 15.9	10.7%	\$ 1.6
Net realized capital gains (losses)	(63.4)	(38.3)	0.1	0.2	(0.3)	(0.3)	94.9	14.3
Total		\$(32.5)		\$ 19.3		\$ 15.6		\$ 15.9
Ending assets (at carrying value)		\$111.8		\$129.8		\$196.4		\$ 10.6
Total before investment expenses								
Gross investment income	8.7%	\$ 61.3	7.2%	\$107.0	7.7%	\$ 97.2	6.2%	\$ 47.9
Net realized capital gains (losses)	(5.5)	\$(38.7)	0.2	2.8	0.7	8.7	1.8	13.5
Total		\$ 22.6		\$109.8		\$105.9		\$ 61.4
Investment expenses	0.1%	\$ 0.7	0.1%	\$ 2.0	0.2%	\$ 3.1	--%	\$ --
Net investment income	8.6%	\$ 60.6	7.1%	\$105.0	7.5%	\$ 94.1	6.2%	\$ 47.9

(1) Yields, which are annualized for interim periods, are based on quarterly average asset carrying values for the six months ended June 30, 2001, and annual average asset carrying values for the years ended December 31, 2000, 1999 and 1998.

FIXED MATURITY SECURITIES

Fixed maturity securities consist primarily of publicly traded debt securities and represented 71% of total international invested assets for both June 30, 2001, and December 31, 2000, 68% as of December 31, 1999, and 88% as of December 31, 1998. Fixed maturity securities were diversified by type of issuer as of June 30, 2001 and for the years ended December 31, 2000, 1999 and 1998 as shown in the following table:

INTERNATIONAL INVESTED ASSETS  
FIXED MATURITY SECURITIES BY TYPE OF ISSUER

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)							
U.S. Treasury securities and obligations of U.S. Government corporations and agencies.....	\$ 0.5	--%	\$ 1.8	--%	\$ 0.7	--%	\$305.4	34%
States and political subdivisions.....	--	--	--	--	--	--	--	--
Non-U.S. governments.....	278.0	34	313.6	32	333.3	39	77.0	9
Corporate-public.....	290.9	35	376.5	39	254.9	30	253.2	28
Corporate-private.....	15.2	2	16.3	2	2.6	--	242.4	27
Mortgage-backed securities and other asset backed securities.....	239.6	29	256.7	27	268.1	31	17.5	2
Total fixed maturities.....	\$824.2	100%	\$964.9	100%	\$859.6	100%	\$895.5	100%

The fixed maturity securities held by the international operations have not been rated by external agencies and cannot be presented in a comparable rating agency equivalent.

The issuers of the majority of our fixed maturity corporate securities are mainly banks and are categorized in the finance, insurance and real estate category as shown in the tables below:

INTERNATIONAL INVESTED ASSETS  
CORPORATE FIXED MATURITY SECURITIES PORTFOLIO BY INDUSTRY AS OF JUNE 30, 2001

INDUSTRY CLASS	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)					
Finance, Insurance and Real Estate.....	\$144.0	49%	\$10.8	71%	\$154.8	51%
Manufacturing.....	0.3	--	--	--	0.3	--
Transportation and Public Utilities.....	39.5	14	--	--	39.5	13
Services.....	39.9	14	4.2	28	44.1	15
Mining.....	--	--	--	--	--	--
Retail.....	28.3	10	--	--	28.3	9
Agriculture, Forestry and Fishing.....	--	--	--	--	--	--
Public Administration.....	1.1	--	--	--	1.1	--
Construction.....	37.8	13	0.2	1	38.0	12
Total.....	\$290.9	100%	\$15.2	100%	\$306.1	100%

INTERNATIONAL INVESTED ASSETS  
CORPORATE FIXED MATURITY SECURITIES PORTFOLIO BY INDUSTRY AS OF DECEMBER 31,  
2000

	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
(\$ IN MILLIONS)						
<b>INDUSTRY CLASS</b>						
Finance, Insurance and Real Estate.....	\$240.3	64%	\$ --	--%	\$240.3	61%
Manufacturing.....	0.3	--	13.3	82	13.6	3
Transportation and Public Utilities.....	100.6	27	--	--	100.6	26
Services.....	9.1	2	2.7	17	11.8	3
Mining.....	--	--	--	--	--	--
Retail.....	26.2	7	--	--	26.2	7
Agriculture, Forestry and Fishing.....	--	--	--	--	--	--
Public Administration.....	--	--	--	--	--	--
Construction.....	--	--	0.3	1	0.3	--
Total.....	<u>\$376.5</u>	<u>100%</u>	<u>\$16.3</u>	<u>100%</u>	<u>\$392.8</u>	<u>100%</u>

INTERNATIONAL INVESTED ASSETS  
CORPORATE FIXED MATURITIES PORTFOLIO BY INDUSTRY AS OF DECEMBER 31, 1999

	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
(\$ IN MILLIONS)						
<b>INDUSTRY CLASS</b>						
Finance, Insurance and Real Estate.....	\$174.5	69%	\$2.6	100%	\$177.1	69%
Manufacturing.....	0.4	--	--	--	0.4	--
Transportation and Public Utilities.....	28.6	11	--	--	28.6	11
Services.....	26.7	10	--	--	26.7	10
Mining.....	--	--	--	--	--	--
Retail.....	15.0	6	--	--	15.0	6
Agriculture, Forestry and Fishing.....	--	--	--	--	--	--
Public Administration.....	9.7	4	--	--	9.7	4
Construction.....	--	--	--	--	--	--
Total.....	<u>\$254.9</u>	<u>100%</u>	<u>\$2.6</u>	<u>100%</u>	<u>\$257.5</u>	<u>100%</u>

INTERNATIONAL INVESTED ASSETS  
CORPORATE FIXED MATURITIES PORTFOLIO BY INDUSTRY AS OF DECEMBER 31, 1998

	PUBLICLY TRADED		PRIVATELY PLACED		TOTAL	
	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL	CARRYING AMOUNT	% OF TOTAL
(\$ IN MILLIONS)						
<b>INDUSTRY CLASS</b>						
Finance, Insurance and Real Estate.....	\$253.2	100%	\$ --	--%	\$253.2	51%
Manufacturing.....	--	--	242.4	100	242.4	49
Transportation and Public Utilities.....	--	--	--	--	--	--
Services.....	--	--	--	--	--	--
Mining.....	--	--	--	--	--	--
Retail.....	--	--	--	--	--	--
Agriculture, Forestry and Fishing.....	--	--	--	--	--	--
Public Administration.....	--	--	--	--	--	--
Construction.....	--	--	--	--	--	--
Total.....	<u>\$253.2</u>	<u>100%</u>	<u>\$242.4</u>	<u>100%</u>	<u>\$495.6</u>	<u>100%</u>

The international operations held \$239.6 million of residential pass-through securities as of June 30, 2001, and \$256.7 million, \$268.1 million and \$17.5 million as of December 31, 2000, 1999 and 1998, respectively.

INTERNATIONAL INVESTED ASSETS  
MORTGAGE AND ASSET-BACKED SECURITIES

	CARRYING AMOUNT AS OF JUNE 30,		CARRYING AMOUNT AS OF DECEMBER 31,	
	2001	2000	1999	1998
(\$ IN MILLIONS)				
Residential pass-through securities.....	\$239.6	\$256.7	\$268.1	\$17.5
Commercial MBS.....	--	--	--	--
Asset-backed securities.....	--	--	--	--
Total MBSs and asset-backed securities.....	\$239.6	\$256.7	\$268.1	\$17.5

The amortized cost and estimated fair value of fixed maturity securities, by contractual maturity dates excluding scheduled sinking funds, as of June 30, 2001, and December 31, 2000 and 1999 were as follows:

INTERNATIONAL INVESTED ASSETS  
FIXED MATURITY SECURITIES BY CONTRACTUAL MATURITY DATES

	AS OF JUNE 30,		AS OF DECEMBER 31,		AS OF DECEMBER 31,	
	2001		2000		1999	
	AMORTIZED COST	CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT	AMORTIZED COST	CARRYING AMOUNT
(\$ IN MILLIONS)						
Due in one year or less.....	\$ 35.3	\$ 36.2	\$ 31.6	\$ 29.2	\$ 49.7	\$ 50.5
Due after one year through five years.....	82.6	85.3	91.8	95.3	63.8	65.8
Due after five years through ten years.....	166.6	170.4	215.6	217.2	122.7	132.1
Due after ten years.....	290.6	292.7	356.4	366.5	334.7	343.1
Subtotal.....	575.1	584.6	695.4	708.2	570.9	591.5
Mortgage-backed and other securities without a single maturity date.....	234.2	239.6	253.5	256.7	272.0	268.1
Total.....	\$809.3	\$824.2	\$948.9	\$964.9	\$842.9	\$859.6

EQUITY SECURITIES

Our equity securities represented 3% of international invested assets as of June 30, 2001, and 6%, 8% and 11% as of December 31, 2000, 1999 and 1998, respectively. Our equity securities consisted of \$32.6 million in mutual funds and \$6.8 million in common stock as of June 30, 2001.

RESIDENTIAL MORTGAGE LOANS

Our Chilean operations originate residential mortgage loans. Residential mortgage loans comprised \$175.1 million, or 15%, of international invested assets as of June 30, 2001 and \$166.9 million, or 12%, as of December 31, 2000.



DERIVATIVES

Our use of derivative instruments includes foreign currency swaps, interest rate swaps and currency forwards. The following tables present our position in, and credit exposure to, derivative financial instruments as of June 30, 2001, and December 31, 2000 and 1999, respectively. We did not use derivatives prior to 1999.

INTERNATIONAL INVESTED ASSETS  
DERIVATIVE FINANCIAL INSTRUMENTS

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	NOTIONAL AMOUNT	% OF TOTAL	NOTIONAL AMOUNT	% OF TOTAL	NOTIONAL AMOUNT	% OF TOTAL	NOTIONAL AMOUNT	% OF TOTAL
	(\$ IN MILLIONS)							
Foreign currency swaps.....	\$ 699.8	40%	\$ 665.0	39%	\$ 670.0	39%	\$ --	--%
Interest rate swaps.....	665.0	38	665.0	39	665.0	39	--	--
Currency forwards.....	380.0	22	380.0	22	380.0	22	--	--
Total.....	\$1,744.8	100%	\$1,710.0	100%	\$1,715.0	100%	\$--	--%

INTERNATIONAL INVESTED ASSETS  
DERIVATIVE FINANCIAL INSTRUMENTS

	AS OF JUNE 30,		AS OF DECEMBER 31,					
	2001		2000		1999		1998	
	CREDIT EXPOSURE	% OF TOTAL	CREDIT EXPOSURE	% OF TOTAL	CREDIT EXPOSURE	% OF TOTAL	CREDIT EXPOSURE	% OF TOTAL
	(\$ IN MILLIONS)							
Interest rate swaps.....	\$ 42.7	27%	\$39.1	42%	\$ --	--%	\$--	--%
Foreign currency swaps.....	68.5	43	28.4	30	14.8	100	--	--
Currency forwards.....	48.5	30	26.2	28	--	--	--	--
Total.....	\$159.7	100%	\$93.7	100%	\$14.8	100%	\$--	--%

OTHER INVESTMENTS

Our other investments totaled \$111.8 million as of June 30, 2001, compared to \$129.8 million as of December 31, 2000 and \$196.4 million as of December 31, 1999. Of the \$111.8 million, \$39.8 million is related to subordinated notes in BT Financial Group's margin lending program, \$36.2 million represents our investment in subsidiaries including Brazil, Japan and India, \$12.9 million represents BT Financial Group's investment in unit trusts, \$22.5 million represents our investment in Chilean operations, and \$0.4 million represents our investment in Mexican operations.

MANAGEMENT

DIRECTORS AND EXECUTIVE OFFICERS

The following table lists our directors and executive officers, their ages and their positions:

NAME	AGE(1)	POSITION
David J. Drury.....	56	Chairman of the Board, Chairman and Director
J. Barry Griswell.....	51	President and Chief Executive Officer and Director
Betsy J. Bernard.....	45	Director
Jocelyn Carter-Miller.....	43	Director
Daniel Gelatt.....	53	Director
Sandra L. Helton.....	51	Director
Charles S. Johnson.....	62	Director
William T. Kerr.....	59	Director
Lee Liu.....	67	Director
Victor H. Loewenstein.....	62	Director
Ronald D. Pearson.....	60	Director
Federico F. Pena.....	53	Director
Donald M. Stewart.....	62	Director
Elizabeth E. Tallett.....	51	Director
John E. Aschenbrenner.....	51	Executive Vice President
Michael T. Daley.....	44	Executive Vice President
Dennis P. Francis.....	57	Senior Vice President
Michael H. Gersie.....	52	Executive Vice President and Chief Financial Officer
Ellen Z. Lamale.....	47	Senior Vice President and Chief Actuary
Mary A. O'Keefe.....	44	Senior Vice President
Richard L. Prey.....	59	Executive Vice President
Karen E. Shaff.....	46	Senior Vice President and General Counsel
Norman R. Sorensen.....	56	Senior Vice President
Carl C. Williams.....	63	Senior Vice President and Chief Information Officer
Larry D. Zimpleman.....	49	Executive Vice President

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 (1) At December 31, 2000.

The following is biographical information for our directors and executive officers:

DAVID J. DRURY has been Chairman of Principal Financial Group, Inc. since April 25, 2001, Chairman of Principal Life since January 2000, a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since 1993. Mr. Drury has announced his retirement as Chairman of Principal Financial Group, Inc. and Principal Life, which he expects to occur following completion of the demutualization. Prior to 2000, Mr. Drury was Chairman and Chief Executive Officer of Principal Life from 1995 to 1999. He is a director of Coventry Health Care, Inc., a managed health care company, and a Fellow of the Society of Actuaries and a member of the American Academy of Actuaries. He chairs the Executive and Investment Committees of the board of directors of Principal Life and is a member of the Board-Management Committee and, effective August 21, 2001, assumed the same positions with Principal Financial Group, Inc.

J. BARRY GRISWELL has been President and Chief Executive Officer of Principal Financial Group, Inc. since April 25, 2001, President and Chief Executive Officer of Principal Life since January 2000, a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since March 1998. Effective upon Mr. Drury's retirement, Mr. Griswell will assume the additional title of Chairman of Principal Financial Group, Inc. and Principal Life. Prior to his current position, Mr. Griswell held the following positions with Principal Life: President from 1998-2000, Executive Vice President from 1996-1998, Senior Vice President from 1991-1996. He is a Chartered Life Underwriter, a Chartered Financial Consultant and a LIMRA Leadership Institute Fellow. He is Chair of the Board-Management Committee and is a member of the Executive and Investment Committees of the board of directors of Principal Life and, effective August 21, 2001, assumed the same positions with Principal Financial Group, Inc. Mr. Griswell serves as a director of the 28 mutual funds that comprise the Principal Family of Mutual Funds.

BETSY J. BERNARD has been a director of Principal Financial Group, Inc. since April 24, 2001, and a Principal Life director since February 1999. Ms. Bernard has been President and Chief Executive Officer of AT&T Consumer since April 2001. Prior to April 2001, she was Executive Vice President -- National Mass Markets of Qwest Communications, formerly U S WEST, from July 2000-January 2001. Prior to July 2000, she was Executive Vice President -- Retail Markets of U S WEST from August 1998-June 2000; President and Chief Executive Officer of U S WEST Long Distance from June 1998-August 1998; President and Chief Executive Officer of Avirnex Communications Group from December 1997-June 1998; President and Chief Operating Officer of Avirnex from July 1997-December 1997; President and Chief

Executive Officer of Pacific Bell Communications, Pacific Telesis from 1995-July 1997; Vice President, Business Market Group of Pacific Telesis in 1995; Customer Service Vice President, Data Communication Services of AT&T 1994-1995. She is a director of Astracon Inc., a company specializing in connectivity intelligence software, Zantaz.com, a firm that provides Internet based services, Portview Communications, a telecommunications company, and Serco Group PLC in the UK. She is a member of the Nominating Committee of the board of directors of Principal Life. Effective August 21, 2001, Ms. Bernard became Chair of the Nominating Committee and a member of the Board-Management Committee of the board of directors of Principal Life and Principal Financial Group, Inc.

JOCELYN CARTER-MILLER has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since February 1999. Ms. Carter-Miller has been Corporate Vice President and Chief Marketing Officer of Motorola, Inc. since February 1999. Prior to February 1999, she held the following positions with Motorola: Vice President, CLQC, Consumer Solutions Group, Personal Communications Sector from 1998-1999; Vice President and General Manager, Worldwide Networks Division from 1997-1998; Vice President of Latin American and Caribbean Operations from 1994-1997. She is a member of the Audit and Strategic Issues Committees of the board of directors of Principal Life and, effective August 21, 2001, assumed the same positions with Principal Financial Group, Inc.

DANIEL GELATT has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since August 1988. Mr. Gelatt has been President of NMT Corporation, a computer software and microfilm service business, since 1986. He is a member of the Executive, Human Resources and Board-Management Committees of the board of directors of Principal Life and Principal Financial Group, Inc.

SANDRA L. HELTON has been a director of Principal Financial Group, Inc. since May 21, 2001 and a Principal Life director since May 21, 2001. Ms. Helton has been Executive Vice President and Chief Financial Officer of Telephone & Data Systems, Inc. since 1998. Prior to 1998, she was Vice President and Corporate Controller of Compaq Computer Corporation from 1997-1998. From 1994-1997, Ms. Helton was Senior Vice President and Treasurer of Corning Incorporated. She is director of Telephone & Data Systems, Inc., a diversified telecommunications corporation. She is a member of the Audit Committee of the board of directors of Principal Life and, effective August 21, 2001, Ms. Helton assumed the same position with Principal Financial Group, Inc.

CHARLES S. JOHNSON has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since October 1995. Mr. Johnson is the retired Executive Vice President of DuPont, a position he held in 1999. Prior to his position with DuPont, he was Chairman, President and Chief Executive Officer of Pioneer Hi-Bred International, Inc. from December 1996-1999, President and Chief Executive Officer from September 1995-December 1996. He is a director of Gaylord Container Corporation, a manufacturer of corrugated containers. He is a member of the Audit and Strategic Issues Committees of the board of directors of Principal Life and, effective August 21, 2001, Mr. Johnson assumed the same positions with Principal Financial Group, Inc., and is a member of the Pricing Committee of the board of directors of Principal Financial Group, Inc.

WILLIAM T. KERR has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since February 1995. Mr. Kerr has been Chairman and Chief Executive Officer of Meredith Corporation since January 1998. He served as President and Chief Executive Officer of Meredith from 1997-1998 and as Meredith's President and Chief Operating Officer from 1994-1997. He is a director of Meredith Corporation, a media and marketing company, Maytag Corporation, a manufacturer of household appliances, and Storage Technology Corporation, a manufacturer of information storage and retrieval devices. Mr. Kerr is Chair of the Human Resources and Strategic Issues Committees and a member of the Executive and Board-Management Committees of Principal Life and Principal Financial Group, Inc. and a member of the Pricing Committee of the board of directors of Principal Financial Group, Inc.

LEE LIU has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since August 1990. Mr. Liu is the retired Chairman of the Board of Alliant Energy Corporation, a position he held from 1998-2000. Prior to his position with Alliant, he was Chairman and Chief Executive Officer of IES Industries from 1996-1999 and was IES's Chairman, President and Chief Executive Officer from 1993-1996. He is a director of Alliant Energy Corporation and Eastman Chemical Company, a manufacturer of industrial products. He is a member of the Executive and Human Resources Committees of the board of directors of Principal Life and Principal Financial Group, Inc.

VICTOR H. LOEWENSTEIN has been a director of Principal Financial Group, Inc. since April 24, 2001 and a director of Principal Life since August 1991. Mr. Loewenstein has been managing partner of Egon Zehnder International, a management consulting firm, since 1979. He is a member of the Nominating Committee of the board of directors of Principal Life and, effective August 21, 2001, assumed the same position with Principal Financial Group, Inc.

RONALD D. PEARSON has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since June 1996. Mr. Pearson has been Chairman, President and Chief Executive Officer of Hy-Vee, Inc., a retail grocer, since 1989. He is a member of the Human Resources Committee of the board of directors of Principal Life and, effective August 21, 2001, assumed the same position with Principal Financial Group, Inc.

FEDERICO F. PENA has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since November 1999. Mr. Pena has been Managing Director of Vestar Capital Partners, an investment firm specializing in management buyouts, recapitalizations and growth capital investments, since 2000. He served as Vestar's Senior Advisor from 1998-2000. Prior to his employment with Vestar, Mr. Pena was Secretary of the U.S. Department of Energy from 1996-1998 and Secretary of the U.S. Department of Transportation from 1993-1996. He is a director of Marsico Funds, which are mutual funds, Valor Communications, a telecommunications company, and Sonic, Inc. He is a member of the Nominating Committee of the board of directors of Principal Life and, effective August 21, 2001, assumed the same position with Principal Financial Group, Inc.

DONALD M. STEWART has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since June 1979. Mr. Stewart has been President and Chief Executive Officer of The Chicago Community Trust, a philanthropic organization, since June 2000. Prior to June 2000, he was Senior Program Officer and Special Advisor to the President at the Carnegie Corporation of New York from July 1999-May 2000, and President of The College Board from 1986-June 1999. He is a director of The Campbell Soup Company, a food and beverage manufacturing firm, and The New York Times Company, a diversified media company. Mr. Stewart is a member of the Nominating Committee of the board of directors of Principal Life and Principal Financial Group, Inc.

ELIZABETH E. TALLETT has been a director of Principal Financial Group, Inc. since April 24, 2001 and a Principal Life director since May 1992. Ms. Tallett has been President and Chief Executive Officer of Galenor Inc., a research pharmaceutical company, since 1999 and has also been President and Chief Executive Officer of Dioscor Inc., a pharmaceutical and biotechnology firm, since 1996. Prior to 1996, she was President and Chief Executive Officer of Transcell Technologies, Inc. She is a director of Coventry Health Care, Inc., a managed health care company, IntegraMed America, Inc., a health services company, Varian, Inc., a supplier of scientific instruments, and Varian Semiconductor Equipment Associates, Inc., a semiconductor equipment company. Ms. Tallett is Chair of the Audit Committee and a member of the Board-Management Committee of the board of directors of Principal Life and Principal Financial Group, Inc. and a member of the Pricing Committee of Principal Financial Group, Inc.

JOHN E. ASCHENBRENNER who heads the Life and Health Insurance and Mortgage Banking segments of our operations has been Executive Vice President of Principal Financial Group, Inc. since April 25, 2001 and Executive Vice President of Principal Life since January 2000. From 1996-1999, he was Senior Vice President of Principal Life and from 1990-1995, he was Vice President -- Individual Markets of Principal Life. Mr. Aschenbrenner serves as a director of the 28 mutual funds that comprise the Principal Family of Mutual Funds.

MICHAEL T. DALEY who heads Marketing and Distribution has been Executive Vice President of Principal Financial Group, Inc. since April 25, 2001 and Executive Vice President of Principal Life since June 2000. From 1997-2000, he was Senior Vice President of CIGNA Retirement and Investment Services and from 1992-1997, he was Managing Director of Bankers Trust Company.

DENNIS P. FRANCIS has been Chief Executive Officer of Principal Capital Management since 1999. He has been Senior Vice President of Principal Financial Group, Inc. since April 25, 2001 and Senior Vice President and Chief Investment Officer of Principal Life since 1998. From 1990-1997, he was Vice President -- Commercial Real Estate of Principal Life.

MICHAEL H. GERSIE has been Executive Vice President and Chief Financial Officer of Principal Financial Group, Inc. since April 25, 2001 and Executive Vice President and Chief Financial Officer of Principal Life since January 2000. From 1994-1999, he was Senior Vice President of Principal Life.

ELLEN Z. LAMALE has been Senior Vice President and Chief Actuary of Principal Financial Group, Inc. since April 25, 2001 and Senior Vice President and Chief Actuary of Principal Life since June 1999. From 1992-1999, she was Vice President and Chief Actuary of Principal Life.

MARY A. O'KEEFE who heads Corporate Relations and Human Resources has been Senior Vice President of Principal Financial Group, Inc. since April 25, 2001 and Senior Vice President of Principal Life since January 1998. From 1994-1997, she was Vice President -- Corporate Relations of Principal Life.

RICHARD L. PREY who heads the U. S. Asset Accumulation business has been Executive Vice President of Principal Financial Group, Inc. since April 25, 2001 and Executive Vice President of Principal Life since January 2000. Mr. Prey has announced his retirement effective January 31, 2002. From 1997-1999, he was Senior Vice President of Principal Life, from 1996-1997, he was Vice President -- Pension of Principal Life and from 1993-1996, he was President and Chief Executive Officer of Delaware Charter Guarantee & Trust Company, an indirect subsidiary of Principal Life.

KAREN E. SHAFF has been Senior Vice President and General Counsel of Principal Financial Group, Inc. since April 25, 2001 and Senior Vice President and General Counsel of Principal Life since January 2000. From June 1999-December 1999, she was Senior Vice President and Deputy General Counsel of Principal Life, and from 1995-May 1999, she was Vice President and Associate General Counsel of Principal Life. She is a director of HealthExtras, Inc.

NORMAN R. SORENSEN has been President of Principal International, Inc. since 1998 and has been Senior Vice President of Principal Financial Group, Inc. since April 25, 2001 and Senior Vice President of Principal Life since December 1998. From 1989-November 1998, he was Vice President and Senior Executive -- Latin America, American International Group.

CARL C. WILLIAMS has been Senior Vice President and Chief Information Officer of Principal Financial Group, Inc. since April 25, 2001 and Senior Vice President and Chief Information Officer of Principal Life since July 1997. From 1993-1997, he was Vice President -- Information Technology of Amoco Oil.

LARRY D. ZIMPLEMAN who leads our global pension expansion efforts and is responsible for pension underwriting, systems and pricing of Principal Life has been Executive Vice President of Principal Financial Group, Inc. and Principal Life since August 25, 2001. Mr. Zimpleman has been named to assume responsibility for the U.S. Asset Accumulation business of Principal Financial Group, Inc. upon Mr. Prey's retirement on January 31, 2002. Prior to his current position, Mr. Zimpleman was Senior Vice President of Principal Life from June 1999-August 2001, Vice President from 1998 - 1999 and Vice President -- Pension from 1994 - 1998.

#### COMPOSITION OF BOARD AND COMMITTEES

Principal Financial Group, Inc. is managed under the direction of its board of directors. Its board of directors was initially composed of 13 directors, 11 of whom were not officers, and has added one additional director, who is not an officer. Principal Financial Group, Inc. has also established the following standing committees of the board of directors:

##### AUDIT COMMITTEE

The Audit committee of Principal Financial Group, Inc. was chosen by the board of directors from those members who are not officers of Principal Financial Group, Inc. or its subsidiaries. The Audit committee will recommend to the board of directors a firm of independent certified public accountants to annually audit the books and records. The Audit committee will review and report on the activities of the independent certified public accountants to the board of directors and review and advise the board of directors as to the adequacy of Principal Financial Group, Inc.'s system of internal accounting controls.

##### HUMAN RESOURCES COMMITTEE

The Human Resources committee of Principal Financial Group, Inc. was chosen by the board of directors from those members who are not officers of Principal Financial Group, Inc. or its subsidiaries. The Human Resources committee will make recommendations to the board of directors regarding salaries and any supplemental employee compensation of the executive officers and act upon management's recommendations for salary and supplemental employee compensation policies for all other employees.

##### OTHER COMMITTEES

The board of directors may form such other committees of the board of directors as it deems appropriate.

#### COMPENSATION OF DIRECTORS

The compensation for our directors who are not officers or employees of Principal Mutual Holding Company or its subsidiaries consists of a \$31,500 annual retainer plus a \$2,500 per day attendance fee for each regular or special board meeting attended in person. These directors are also compensated for participation on committees. We anticipate that, following the conversion, the directors of Principal Financial Group, Inc. will be identical to the directors of Principal Life. We do not currently plan to pay any additional compensation to directors for also participating on the board of directors of Principal Life.

In addition, following the conversion, directors who are not officers or employees will receive initial and annual grants of options and are eligible for discretionary grants of options pursuant to the directors stock plan. Non-employee directors also receive an initial grant of RESTRICTED STOCK UNITS and a grant of Restricted Stock Units upon re-election to the board, and are eligible for discretionary grants of RESTRICTED STOCK or Restricted Stock Units pursuant to the directors stock plan. The annual retainer payable to directors will be reduced by \$7,500 upon the grant of awards under the directors stock plan. A description of our directors stock plan is provided below.

Principal Financial Group, Inc. intends to adopt a directors deferred compensation plan pursuant to which each non-employee director who receives a cash retainer and meeting fees would have the right to defer all or a portion of such payments into an account. The deferred payments would be deemed to be invested in common stock.

COMPENSATION OF NAMED EXECUTIVE OFFICERS

Since the formation of Principal Financial Group, Inc. in April of 2001, none of its officers or other personnel has received any compensation from Principal Financial Group, Inc. All compensation has been paid to such individuals in their capacities as officers and/or directors of Principal Life. It is expected that after the demutualization, most of the employees of Principal Financial Group, Inc., including the executive officers, will continue to be paid only by Principal Life with an allocation of their compensation to be made for services rendered to Principal Financial Group, Inc. Principal Financial Group, Inc. will pay the amount of such allocation to Principal Life pursuant to a cost allocation agreement. If and to the extent any employees of Principal Financial Group, Inc. cease to also be employees of Principal Life, their entire salary will be paid by Principal Financial Group, Inc.

The following table sets forth the compensation paid to our chief executive officer and the four other most highly compensated executive officers employed as of December 31, 2000, for services rendered during the fiscal year ended December 31, 2000:

SUMMARY COMPENSATION TABLE

NAME AND PRINCIPAL POSITION	YEAR	SALARY	BONUS(1)	LTIP PAYOUTS(2)	ALL OTHER COMPENSATION(3)
J. Barry Griswell President, CEO.....	2000	\$841,346	\$378,606	\$316,888	\$33,783
David J. Drury Chairman.....	2000	825,000	371,250	479,538	37,205
Michael H. Gersie EVP, CFO.....	2000	333,269	134,974	303,737	13,978
Richard L. Prey EVP.....	2000	328,269	132,949	301,087	12,592
John E. Aschenbrenner EVP.....	2000	318,269	128,899	295,727	13,211

(1) The amounts shown represent the 2000 incentive compensation awards paid in 2001 under the Principal Financial Group incentive pay plan.

(2) The amounts shown represent the payout of the 1998 long-term performance award in respect of the 1998 through 2000 cycle under the Principal Financial Group long-term performance plan. Amounts shown include amounts paid as well as deferred.

(3) The amounts shown represent the total of our contributions to our employees savings plan in which all of our employees are generally eligible to participate, and contributions to our excess plan, our non-qualified supplemental executive retirement plan. For the year ending December 31, 2000, our contribution to the employees savings plan for each named executive officer was \$3,938 (the maximum allowable contribution under the plan). Our contributions to the excess plan for the year ending December 31, 2000, for these officers were as follows: Mr. Griswell, \$29,845; Mr. Drury, \$33,267; Mr. Gersie, \$10,040; Mr. Prey, \$8,654; and Mr. Aschenbrenner, \$9,273. The amount set forth for Mr. Prey in this column does not include matching contributions made by us in the year 2000 in respect of his salary and bonus for 1999.

EMPLOYMENT AGREEMENTS

We have previously entered into an employment agreement with J. Barry Griswell, pursuant to which Mr. Griswell will continue in his capacity as our president and chief executive officer for an employment term of three years from the date of the employment agreement. This three-year term will automatically be extended for additional two-year terms unless either Mr. Griswell or we notify the other of the intention not to extend the agreement. Mr. Griswell's annual salary under this agreement is \$850,000, periodically increased in accordance with our regular policy, and he participates in our incentive compensation plans, long-term performance plan and qualified and non-qualified savings and retirement plans.

The employment agreement provides that Mr. Griswell would be entitled to certain severance benefits in the event that his employment terminates under certain circumstances. These benefits are substantially similar to the severance benefits to which Mr. Griswell would be entitled pursuant to the "change in control" agreement described below, except that in the case of a termination of his employment where there has not been a change of control, Mr. Griswell, pursuant to the terms of his employment agreement, will generally be entitled to two times the amounts indicated below, not three times.

We have entered into "change in control" employment agreements with Mr. Griswell and with each of the other named executive officers that provide each executive with assurances as to the terms and conditions of his

employment and as to the termination benefits that would be payable to him upon a termination of employment relating to a change of control (as defined in the agreements and as set forth below). The purpose of these agreements is to assure the covered executive that, following a change of control or related events, he will receive substantially comparable compensation and benefits and have substantially comparable terms and conditions of employment as those he enjoyed prior to the occurrence of such event. To that end, in the event of a change of control, these agreements:

- mandate that the executive receive specified levels of salary, incentive compensation and benefits for a period of not less than two years following the occurrence of a change of control;
- provide for the immediate vesting of all options and shares of Restricted Stock then held by each executive, unless the applicable merger agreement provides that the options are to be assumed by the acquirer, in which case only the Restricted Stock will vest; however, there can be no exercise of options nor distribution of Restricted Stock awards until eighteen months following the completion of the demutualization;
- provide for a payment to be made to each executive, within 10 days of a change of control, of a pro rata portion of any annual bonus and/or long-term incentive award then outstanding, in respect of the applicable periods prior to the change of control;
- provide that each executive will vest and be paid, within 10 days of a change of control, the outstanding account balances under any non-qualified deferral or supplemental benefits program, whether vested or unvested; and
- assure each executive of receiving a specified level of termination benefits in the event that his employment is terminated without "cause" or by the executive voluntarily for "good reason."

For this purpose, good reason means adverse changes in the terms and conditions of the executive's employment, including:

- any failure to pay the executive's base salary or any required increase in salary;
- any failure to pay the executive's annual bonus or any reduction in the executive's annual bonus opportunity;
- any material adverse change in the executive's position (including offices, titles or reporting requirements, but not reporting responsibilities), authority or duties under the agreement; or
- any material reduction in the executive's aggregate compensation and benefits or requiring the executive to be based at any office or location other than the location at which he worked prior to the change of control.

The benefits to be paid or provided under the agreements upon a qualifying termination include:

- a lump sum severance benefit equal to three times the sum of the executive's annual base salary, target annual bonus and annualized target long-term bonus; provided that the annualized target long-term bonus will not be included as part of the severance benefits if the executive's termination occurs on or after the third anniversary of the date we first make a grant of stock options to a peer executive;
- the immediate vesting of all stock options and shares of Restricted Stock or similar awards then held, except that there can be no option exercise or distribution of Restricted Stock until eighteen months following the completion of the demutualization;
- a pro-rated annual bonus for the year of termination and a pro-rated long-term incentive plan payment for each cycle then in progress, minus, in each case, the amount, if any, paid in respect of such annual or long-term incentive plan at the time of the change of control;
- the unpaid account balances under any non-qualified deferral or supplemental benefits program, whether vested or unvested;
- the lump sum value of the additional retirement benefits the executive would have accrued had he or she become fully vested in all such previously-unvested benefits, accrued three additional years of service and received the lump-sum severance benefits described above, excluding the long-term incentive plan bonuses, as covered compensation during such assumed additional years of service;
- an additional payment to offset any excise tax imposed under section 4999 of the Internal Revenue Code, but only if the after-tax amount of the additional payment would exceed 10% of the after-tax benefits the executive would receive if the executive's benefits were limited to an amount such that the payments would not be subject to the excise tax; and
- the reimbursement for legal fees and other related expenses required to secure, preserve or obtain benefits under the agreement.

In addition, until the third anniversary of the date of the executive's termination, the executive shall continue to receive welfare benefits, including medical, prescription, dental, disability, salary continuance, individual life, group life,





accidental death and travel accident insurance plans and programs, which are at least as favorable as the most favorable programs at the same costs applicable to peer executives and their families who are actively employed after such termination date.

In exchange for these benefits, Mr. Griswell has agreed that for two years, and the other named executive officers have agreed that for one year, following a termination of employment that results in the executive receiving severance benefits as described above, the executive will not engage or participate in, or become employed by or serve as a director of or consultant to, a competing business; nor will the executive solicit employees or customers, or interfere with the relationship we have with our employees or customers.

For purposes of these agreements, following the effective date of this offering, a change of control will mean any one or more of the following events:

- any person becoming the beneficial owner of 25% or more of our common stock;
- the individuals then serving as members of our board of directors who were members of such board as of the date of the agreement cease for any reason to constitute at least a majority of the board of directors, provided that, for this purpose, any subsequently-appointed or elected member of the board of directors whose election or nomination for election (unless such election, nomination or appointment was in connection with an actual or threatened proxy contest) was approved by a vote or written consent of at least a majority of the incumbent directors then in office and the directors elected or nominated in a manner consistent with the conditions of this provision shall be treated as an incumbent director; or
- the consummation of a merger, reorganization, consolidation or similar transaction other than a transaction immediately following which the stockholders of Principal Financial Group, Inc. continue to own more than 60% of the voting securities of the surviving corporation or its ultimate parent corporation; or approval by the stockholders of Principal Financial Group, Inc. of a plan or agreement for the sale or other disposition of all or substantially all of its consolidated assets or a plan of liquidation.

However, if specific conditions are met, a reorganization transaction of the type outlined in the third item above may not trigger the full protection otherwise afforded to management under such agreements because the requisite conditions will afford management reasonable protection that there will be a reasonable continuity of the business conditions that existed prior to the occurrence of such event. These conditions are that:

- immediately following any such transaction, the stockholders of Principal Financial Group, Inc. must continue to own more than 40% of the voting securities of the surviving corporation or its ultimate parent corporation;
- no person is or becomes the beneficial owner of 25% or more of the voting securities of the corporation surviving such reorganization transaction, or its parent;
- for two years, directors who were in office immediately preceding the reorganization transaction continue to constitute not less than (i) a majority of the board of directors if, immediately following any such transaction, the stockholders of Principal Financial Group, Inc. continue to own more than 50% of the voting securities of the surviving corporation or its ultimate parent corporation or (ii) one member less than a majority of the board of directors, if immediately following any such transaction, the stockholders of Principal Financial Group, Inc. continue to own more than 40% but less than 50% of the voting securities of the surviving corporation or its ultimate parent corporation; and
- the person who was the chief executive officer of Principal Financial Group, Inc. immediately prior to the first to occur of (x) the day prior to the first occurrence of certain events leading to the transaction or (y) the day prior to the effective date of the transaction shall serve as the chief executive officer of the surviving corporation at all times during the period commencing on the effective date and ending on the first anniversary of the effective date.

If any of the conditions described in the second, third or fourth items above cease to be satisfied, then the full benefit of the protection afforded under such agreements will become operative.

We have entered into a retirement agreement with Richard L. Prey to secure his services through January 31, 2002. Under this retirement agreement, Mr. Prey will continue in our employ through January 31, 2002, with the right to participate through that date in all compensatory plans and arrangements generally made available to officers at his level. In exchange for his commitment to remain in our employ, and for certain other concessions, we have agreed to continue to pay his base salary following his termination of employment for six additional months, through July 31, 2002. Thereafter, Mr. Prey will be treated as a retiree under our pension and retiree medical plans.

#### STOCK INCENTIVE PLAN

Our Human Resources committee will be responsible for administering the Principal Financial Group, Inc. stock incentive plan. Under the stock incentive plan, the Human Resources committee may from time to time grant to our officers, employees and agents stock options, STOCK APPRECIATION RIGHTS, Restricted Stock



The Human Resources committee may not grant any awards to employees or agents under the stock incentive plan that will take effect prior to 30 days following the completion of the demutualization and may not make any grants to any of our executive officers until six months after the completion of the demutualization.

The maximum number of shares of common stock that may be issued under the stock incentive plan, together with the excess plan (our non-qualified defined contribution retirement plan), the directors stock plan described below, the long-term performance plan described below and any new plan awarding our common stock, in the five years following the completion of the demutualization, is 6% of the number of shares outstanding immediately following the completion of the demutualization, unless shareholders vote to increase the maximum number. The number of shares that may be awarded in the eighteen months following the completion of the demutualization is limited to 40% of such maximum. During any three-year period, no individual participant may be granted awards in respect of more than 10% of the total shares available for issuance under the plan.

The Human Resources committee may permit participants to defer receipt of shares of common stock that would otherwise be issued in connection with an award under the plan.

The Human Resources committee intends to make a one-time, nonrecurring grant of options to most of our employees including our agents who are statutory employees, 30 days after the completion of the demutualization. The purpose of this one-time company-wide grant is to encourage the work force to be aware of the impact that their performance can have on the financial success of the enterprise taken as a whole. Employees with a title equivalent or senior to Second Vice President will not participate in the one-time company-wide grant. None of the participants in the long-term performance plan described below will participate in the one-time company-wide grant. Each option granted in the one-time company-wide grant will become exercisable in full on the date which is three years from the date of the one-time company-wide grant.

The shares to be issued under the stock incentive plan may be unissued shares or treasury shares. Upon the occurrence of events that affect our capitalization, appropriate adjustments may be made in the number and kind of shares that may be issued under the stock incentive plan in the future and in the number and kind of shares and price per share under all outstanding stock options and Stock Appreciation Rights granted before the event. Notwithstanding the foregoing, if any grant made under the stock incentive plan is for any reason canceled, terminated or otherwise settled without the issuance of some or all of the shares of common stock subject to the grant, such shares will be available for future grants.

The Human Resources committee may condition the grant of any option or other award upon the recipient agreeing to conditions or covenants in favor of Principal Financial Group, Inc. and/or one or more of its subsidiaries that may have effect following the termination of the recipient's employment. These conditions and covenants may include restrictions on the ability to transfer the underlying shares of common stock or covenants not to compete, not to solicit employees and customers and not to disclose confidential information. The Human Resources committee may also require that, after an option or other award has been exercised, the recipient disgorge any profit, gain or other benefit received from the option if the optionee breaches any of these commitments. These provisions will not apply to the one-time company-wide grant described above.

The Human Resources committee may grant nonqualified stock options to officers, employees and agents and may grant stock options qualifying as incentive stock options under the Internal Revenue Code to officers and employees, including agents who are statutory employees. The maximum number of shares issuable pursuant to incentive stock options that may be awarded under the plan is 10,000,000. The exercise price per share of common stock subject to either a nonqualified stock option or an incentive stock option will be not less than the fair market value, as defined in the stock incentive plan, of such share on the date of grant. To exercise an option, an option holder may pay the exercise price in cash or, if permitted by the Human Resources committee, by delivering on the date of exercise other shares of common stock having an aggregate fair market value equal to the exercise price of the option or by delivering some combination of cash and other shares of common stock. An option may also be exercised through an arrangement with a broker approved by the Human Resources committee whereby payment of the exercise price is accomplished with the sale of common stock.

Other than options granted with respect to the one-time company-wide grant as described above, each option will generally become exercisable in three approximately equal installments on each of the first three anniversaries of the date of the grant of the option. The term of each option will be fixed by the Human Resources committee but may not be more than ten years from its date of grant. Notwithstanding any other provision of the plan, no option shall become exercisable earlier than 18 months following the completion of the demutualization, except in cases of accelerated exercisability due to death or disability of any employee, due to the approved retirement of any employee who is below the level of Second Vice President or, in limited circumstances, as approved by the Insurance Commissioner of the State of Iowa.

In the event an employee terminates service by reason of disability or death, all options then held by the employee, whether or not then exercisable, will become immediately exercisable and will generally remain exercisable for a period of three years or for such shorter period as the Human Resources committee shall determine at the time of grant. In the event an employee terminates service by reason of normal or approved early retirement, all options then held by



the employee will become immediately exercisable and will remain exercisable for a period of three years or for such other period as the Human Resources committee shall determine at the time of grant, subject to the last sentence in the previous paragraph. In the event an employee's service terminates for cause or by resignation, other than in the circumstances addressed above, he or she will lose all of his or her outstanding options, whether or not then exercisable. In general, in the event an employee terminates service for any reason other than those listed above, all options then held by the employee that are then exercisable will remain exercisable for a period of 90 days. Of course, regardless of the rules regarding when an option can be exercised after termination, no option will be exercisable after its stated maximum term.

The Human Resources committee may also grant Stock Appreciation Rights to employees, officers and agents that can either be free standing awards or awards that are related to a stock option in such a way that the exercise of either the Stock Appreciation Right or the stock option will cause the cancellation of the other award. The terms and conditions applicable with respect to any grant of a Stock Appreciation Right will be substantially the same as apply to the grant of a stock option. This means that the vesting of a Stock Appreciation Right, and the time that a recipient of a Stock Appreciation Right will have to exercise the Stock Appreciation Right after the termination of his or her service with Principal Financial Group, Inc. and its affiliates, will be substantially the same as applies to a stock option.

Upon the exercise of a nonqualified option, the option holder will generally recognize ordinary income in an amount equal to the difference between the then fair market value of the common stock being purchased and the exercise price paid to acquire such stock. We will generally be entitled to take a federal income tax deduction in the amount of ordinary income recognized by the employee. Upon the sale of the underlying stock after satisfying the holding period requirement that the stock be held for one year following the exercise of the option, an employee will recognize long-term capital gain (loss) to the extent that the sale price received exceeds (or is less than) the fair market value of the stock at the time of exercise. The tax treatment of a Stock Appreciation Right is essentially the same as is applicable in respect of a nonqualified stock option.

The exercise of an incentive stock option generally does not result in any federal income tax consequences. Upon the sale of the underlying stock after satisfying the applicable holding period requirements, including a requirement that the stock be held until one year following the exercise of the option and two years following the date of grant, an employee will recognize long-term capital gain (loss) to the extent that the sale price received exceeds (or is less than) the price paid to purchase the stock. If the holding periods are not satisfied, the tax consequences with respect to an incentive stock option are generally the same as those that apply to a nonqualified stock option, except that the amount of ordinary income realized by the employee will not exceed the excess of the amount received by an employee in any sale over the employee's exercise price to purchase the stock.

The Human Resources committee also has the right to grant awards of Restricted Stock to our employees, officers and agents at such times and for such number of shares of common stock as the Human Resources committee may determine. The Human Resources committee may elect to grant any such person Restricted Stock Units, which are contractual rights to receive shares of common stock or cash in an amount equal to the value of a specified number of shares of common stock in the future, after the satisfaction of specified vesting conditions, that is the economic equivalent of an award of Restricted Stock. Any such award of Restricted Stock Units shall be in substantially the same terms as an award of Restricted Stock. Notwithstanding any other provision of the plan, no award shall become exercisable or distributable earlier than 18 months following the completion of the demutualization, except in cases of accelerated exercisability or distribution due to death or disability of any employee, due to the approved retirement of any employee who is below the level of Second Vice President or, in limited circumstances, with the approval of the Insurance Commissioner of the State of Iowa.

Unless the Human Resources committee otherwise specifies at the time of grant, a pro rata portion of any shares related to Restricted Stock held by an employee, officer or agent whose service terminates due to his or her death, disability or approved retirement, will vest at such termination, based upon his or her service completed through such date of termination, subject to the requirements of the last sentence in the previous paragraph. Upon any other termination, any shares of Restricted Stock that have not previously vested will be forfeited unless the Human Resources committee otherwise determines.

Generally, an employee, officer or agent who receives Restricted Stock will be entitled to receive all dividends and other distributions paid with respect to those shares. However, if any dividends or distributions are paid in shares of common stock, the shares received as a dividend or distribution will be subject to the same forfeiture restrictions and restrictions on transferability as apply to the Restricted Stock with respect to which they were paid. Additionally, the Human Resources committee may specify at the date of grant that any cash dividends on shares of Restricted Stock will not be paid currently, but rather be credited to an account established for the benefit of the recipient of the Restricted Stock and invested in shares of common stock on the distribution date of such dividend. Any additional shares credited in respect of dividends shall become vested and nonforfeitable, if at all, on the same terms and conditions as are applicable in respect of the Restricted Stock with respect to which such dividends were payable.

Generally, an employee, officer or agent who receives Restricted Stock will have ordinary income at the time that the Restricted Stock is no longer subject to forfeiture in an amount equal to the fair market value of the common stock



at that time less the amount, if any, paid for the Restricted Stock. Such a person may elect, within 30 days of the date of any Restricted Stock grant, to be taxed at the time of the grant based on the then current value of the common stock.

Upon the occurrence of a change of control, as defined above with respect to the change of control employment agreements, all outstanding options and Stock Appreciation Rights shall immediately become exercisable, the restrictions applicable to any Restricted Stock or Restricted Stock Unit award shall lapse and any such award may be cashed out at the discretion of the Human Resources committee; except that no such acceleration of exercisability or lapse of restrictions shall occur prior to eighteen months following the completion of the demutualization. However, unless provided otherwise in change of control employment agreements, if the Human Resources committee determines that the acquiring or surviving entity, or a parent of such entity, will replace the outstanding options, Stock Appreciation Rights and awards of Restricted Stock and Restricted Stock Units or otherwise assume and honor such options, Stock Appreciation Rights or awards on terms that preserve their economic value at the time of the change of control and protect the employees against a forfeiture arising out of an involuntary or specified types of constructive termination, the ability of the employees to exercise options or Stock Appreciation Rights will not accelerate and the restrictions related to Restricted Stock and Restricted Stock Units will not lapse at the time of the change of control.

Our board of directors may terminate, suspend or amend the stock incentive plan at any time, but such termination, suspension or amendment may not adversely affect any stock options, Stock Appreciation Rights or Restricted Stock or Restricted Stock Unit awards then outstanding under the stock incentive plan without the consent of the recipients of such an award. Our board of directors may not amend the plan without the approval of the Insurance Commissioner of the State of Iowa in the eighteen months following the completion of the demutualization. Unless earlier terminated by action of our board of directors, the stock incentive plan will continue in effect until the tenth anniversary of the date the stock incentive plan was adopted. Stock options and Stock Appreciation Rights granted prior to such date will continue in effect until they expire in accordance with their terms.

#### LONG-TERM PERFORMANCE PLAN

We also maintain the Principal Financial Group, Inc. long term performance plan, which provides the opportunity for eligible executives to share in the success of Principal Financial Group, Inc., if specified minimum corporate performance objectives are achieved over a three calendar year period. Under the long-term plan, senior officers are awarded a number of performance units at the discretion of the Human Resources committee. Over the three year performance period, the number of performance units held by an executive will be adjusted by a performance multiplier. This multiplier is a percentage determined based on a matrix established by the Human Resources committee at the beginning of the performance period. The matrix will establish the various performance objectives to be achieved and the levels of reward that participating employees will receive at stated levels of performance. The amount payable to each eligible executive is equal to the product of the number of performance units initially awarded, multiplied by the percentage derived from the performance matrix, and by the value of such unit as determined at the end of the performance period. Currently, the value of a performance unit is determined using a multiple of 10 times the product of the average return on equity for the prior three years and the adjusted consolidated GAAP equity as of the end of the performance period, divided by the number of initial performance units for that performance period. For the performance period commencing after the date of this offering, the value of a performance unit will be equal to the average 20 day trading price of the common stock at the end of the last year in the performance period. For performance periods already commenced but not completed when this offering occurs, the Human Resources committee may determine the value of a performance unit based on the above formula or the price of the common stock on a date determined by the Human Resources committee. For this purpose, to assure that each participant does not receive a penalty or a windfall in the event performance units are based on the stock price, the number of performance units outstanding will be adjusted by the Human Resources committee to reflect the relative values of the common stock and the outstanding performance units at such time. Notwithstanding the foregoing, in no event shall any payment be made in respect of any performance period if the threshold performance objectives established by the Human Resources committee with respect to such performance period are not satisfied. Unless the Human Resources committee shall otherwise determine, payment of such amount shall be made in cash, stock or a combination of cash and stock. If any stock is used for payment, the maximum number of shares that can be awarded under this plan, together with our stock incentive plan described above, the excess plan (our non-qualified defined contribution retirement plan), the directors plan described below, and any new plan awarding our common stock, in the five years following the completion of the demutualization is 6% of the number of shares outstanding immediately following the completion of the demutualization, unless the shareholders vote to increase the maximum number, and the number of shares that may be awarded in the eighteen months following the completion of the demutualization is limited to 40% of such maximum. No awards or payments in the form of stock may be made under the long-term performance plan prior to six months following the completion of the demutualization.

Generally, an executive who receives a grant of performance units must remain employed by Principal Financial Group, Inc. or one of its subsidiaries for the entire performance period to receive any payment under the long-term plan. In the event of termination of employment due to an executive's death, disability or qualifying retirement, all or, if the termination occurs in the first year of the performance period, a pro-rated portion of the amount that would have





been payable to the executive had he or she continued to be employed will still be paid to such executive. An executive may elect to defer payment of all or a portion of amounts otherwise payable under the long-term performance plan for up to five years or until the termination of the executive's employment. No amounts other than those previously deferred will be payable to an executive whose employment is terminated for cause.

Listed below are the awards granted in 2000 under the terms of the long-term plan with respect to the 2000-2002 performance period. The threshold objectives for this period are:

- consolidated GAAP equity, as adjusted, for the year ending simultaneously with the end of the performance period, stated as a percentage of the general account assets of Principal Life, must be at least 6%;
- the risk based capital ratio of Principal Life must be at least 150%;
- the return on equity for the last calendar year in the performance period must exceed a minimum level established for such performance period in the performance matrix; and
- operating earnings must exceed a minimum level established for such performance period in the performance matrix.

The sum of all awards payable pursuant to any performance period shall not exceed 5% of pre-tax GAAP operating earnings for the third year of the performance period.

Within ten (10) days following a change of control or the date the full conditions protecting management in the event of a reorganization transaction fail to be satisfied, as outlined above under "Employment Agreements", executive officers and specified other senior officers including the executive officers shall receive under the plan a pro-rated award for service rendered prior to such date.

LONG-TERM INCENTIVE PLANS -- AWARDS IN LAST FISCAL YEAR

NAME	NUMBER OF PERFORMANCE UNITS(1)	PERFORMANCE PERIOD UNTIL MATURATION OR PAYOUT	ESTIMATED FUTURE PAYOUTS BASED ON CURRENT FORMULA		
			THRESHOLD(2)	TARGET(3)	MAXIMUM(4)
J. Barry Griswell President, CEO.....	13,314	12/31/02	\$ 0	\$1,373,472	
David J. Drury Chairman.....	12,922	12/31/02	0	1,333,033	
Michael H. Gersie EVP, CFO.....	4,198	12/31/02	0	433,065	
Richard L. Prey EVP.....	4,135	12/31/02	0	426,566	
John E. Aschenbrenner EVP.....	4,010	12/31/02	0	413,671	

(1) The number of performance units granted is determined by reference to the three year average return on equity for calendar years 1997 through 1999 and other factors including job level. Following this offering, the number of performance units may be adjusted by the Human Resources committee to reflect the relative values of common stock and the number of performance units outstanding at such time.

(2) Payouts under the plan will be zero if minimum performance targets are not met.

(3) Principal Life did not achieve target in the year 2000. See the Summary Compensation Table above for payout information with respect to the year 2000.

(4) Because the formula may be based on the Principal Financial Group, Inc. common stock price in December 2002, the payout under the plan could be unlimited.

INCENTIVE PAY PLAN (PRINPAY)

We also maintain the Principal Financial Group, Inc. incentive pay plan, which each year provides the opportunity for most of our employees to receive additional incentive compensation if specified minimum corporate performance objectives are met for that year. Each eligible employee under the incentive pay plan is given an award opportunity, which is a fixed percentage of the employee's base salary. The amount actually payable in respect of such award opportunity will be adjusted, up or down, based on our actual performance against one or more corporate financial or non-financial measures established by the Human Resources committee for the plan year. Business unit performance measures are determined by the plan administrator. Awards to the named executive officers and other senior officers are based entirely on corporate performance. The measures of corporate performance that may be used under the plan include, but are not limited to, return on equity, operating earnings, earnings before income taxes, depreciation and amortization, budget, customer satisfaction and total shareholder return. Individual performance objectives are also



established with respect to more senior employees. Different measures of performance may be used for different employees and the weight afforded to any performance measure may also vary from employee to employee.

However, if any threshold performance objective is not met, no amount will be payable under the incentive pay plan for the applicable year. For 2001 and beyond, unless otherwise specified by the Human Resources committee by March 15 in a subsequent plan year, the threshold objectives are:

- Principal Life must maintain the minimum rating from 2 of the 3 specified rating agencies;
- adjusted consolidated GAAP equity for the end of the plan year, stated as a percentage of the general account assets of Principal Life, must be at least 6%; and
- Principal Life must have a risk based capital ratio of at least 150%.

In no event will the sum of all annual awards under the plan exceed 6% of our pre-tax GAAP operating earnings for the fiscal year. No payment shall be made to any participant who is on final warning any time during the plan year.

Award payments under the incentive pay plan are made in cash following the release of audited results after the end of the plan year in which they are earned, but no later than March 15 of the year following the year in which the services are performed. Generally, a participant must remain in our employ through the end of the plan year, which corresponds to the calendar year, to receive any payment with respect to that plan year. If a participant's employment is terminated due to death during the plan year, his or her beneficiary will receive an early distribution based on the participant's salary received during the plan year multiplied by the deceased employee's award opportunity. If a participant dies after the end of a plan year, his or her beneficiary shall receive a distribution in accordance with the plan at the same time as other participants. If a participant terminates employment due to disability, retirement or such other involuntary termination, he or she will receive a prorated distribution at the same time as the other participants. If a participant's employment is terminated for cause, he or she will not be entitled to receive any further payment with respect to any plan year.

Within ten (10) days following a change of control or the date the full conditions protecting management in the event of a reorganization transaction fail to be satisfied, as outlined above under "Employment Agreements," executive officers and specified other senior officers including the executive officers shall receive under the plan a pro-rated award for service rendered prior to such date.

#### EMPLOYEE STOCK PURCHASE PLAN

We also have an employee stock purchase plan called the Principal Financial Group, Inc. employee stock purchase plan. The purchase plan offers virtually all employees the opportunity to buy shares of common stock of Principal Financial Group, Inc. at a discount from the prevailing fair market value of our stock. Participation under the plan will commence no earlier than 30 days following the completion of the demutualization, except that executives may not commence participation until six months after the completion of the demutualization. The number of shares of common stock issuable pursuant to options under the plan may not exceed 2% of the total number of shares outstanding immediately following this offering.

Generally, all employees of Principal Financial Group, Inc. and its subsidiaries will be eligible to join the purchase plan. However, the plan administrator has discretion to exclude all of the employees of specific subsidiaries, as well as employees whose customary employment is 20 hours or less per week, employees whose customary employment is not for more than five months in any calendar year and highly compensated employees (but only to the extent necessary to comply with demutualization requirements). Additionally, any employee who owns 5% or more of the total voting power of all classes of stock is excluded from participating in the plan.

Under the purchase plan, participating employees are granted options, each with a term of not more than 2 years, to purchase shares of common stock of Principal Financial Group, Inc. at a price no less than 85% of the share's fair market value as of the date of grant. The Human Resources committee has determined that the exercise price may be as low as 85% of the share's fair market value as of the exercise date, provided that the exercise date price is less than the grant date price. The phrase "fair market value" is defined by the purchase plan to be the per share closing price of the shares reported on the principal exchange, or the last reported trade on the national quotation system, on which such transactions are reported for the trading day immediately preceding the grant date, or the exercise date, if applicable.

An employee may join the purchase plan by authorizing after-tax payroll contributions to be deducted from gross wages. Additionally, if an employee is making payroll contributions, the administrator of the plan will permit him or her to also make cash contributions. The maximum amount which an employee may contribute during any plan year is the lesser of \$10,000 (or such greater or lesser amount as determined by the plan administrator) and 10% of the employee's salary. An employee may change the amount of payroll contributions to his or her individual account at such intervals as are permitted under the purchase plan. An employee also has the right to completely cease making any further contributions at any time.

There will be at least one exercise date each year. Generally, this date will be the last business day of the calendar year. The plan administrator may select other exercise dates, in its discretion. The Human Resources committee has determined that the initial grant of options to be made no earlier than 30 days following completion of the demutualization will have an accelerated exercise date and, thereafter, there will be exercise dates every three months. Prior to any exercise date, each employee may elect to withdraw the contributions made to the employee's account during that offering period. Unless an employee elects such a withdrawal, on the exercise date the cash balance in the employee's account will be used to purchase the maximum number of shares of common stock that can be purchased with such balance. An employee is not permitted to purchase shares pursuant to options granted under the purchase plan which exceed \$25,000 in fair market value in any calendar year, due to the Internal Revenue Code requirements. If the employee elects not to have his or her options exercised, his or her contributions for that offering period will be distributed to him or her. Purchased shares will be held by the plan custodian until such time as the participating employee either requests a distribution or terminates employment.

Generally, if an employee leaves Principal Financial Group, Inc. or one of its subsidiaries for any reason other than death or permanent disability, any outstanding options granted to him or her will terminate and his or her individual account will be returned to him or her. If an employee's employment terminates due to death or permanent disability, the employee or his or her designated beneficiary, as applicable, will have the option to elect either to have the employee's contributions distributed or to have the employee's options exercised at the next date of exercise.

Our board of directors may terminate, suspend or amend the purchase plan at any time, but such termination, suspension or amendment may not adversely affect any options then outstanding under the purchase plan without the consent of the recipients of those options. Our board of directors may not amend the plan without the approval of the Insurance Commissioner of the State of Iowa in the eighteen months following the completion of the demutualization. The shares to be issued under the purchase plan may be authorized but unissued shares. Upon the occurrence of events that affect our capitalization, appropriate adjustments may be made in the number and kind of shares that may be issued under the purchase plan in the future and in the number and kind of shares and price per share under all outstanding grants made before the event. If any grant is for any reason canceled, terminated or otherwise settled without the issuance of some or all of the shares subject to the grant, such shares will be available for future grants.

If a third party acquires Principal Financial Group, Inc., employee contributions are protected and will never be forfeited. With respect to granted options, generally, one of two scenarios will occur: (1) unless the board of directors determines otherwise, the purchase plan will terminate and all shares and cash contributions in each employee's account will be distributed to the employees; or (2) the third-party or new entity may offer to substitute options for its shares in exchange for the employees' options to buy shares. For shares an employee has already purchased, the employee will be treated like every other stockholder.

The grant of an option to purchase shares will not have any tax consequences. Upon the exercise of an option, an employee will not be required to report any taxable income or pay any tax provided that the employee is employed by Principal Financial Group, Inc. or a subsidiary at the time of exercise.

Upon the sale of shares acquired through the purchase plan, an employee will recognize ordinary income to the extent that the price he or she paid for the shares was less than the fair market value of the shares at the date of grant of the opportunity to purchase the shares. Any excess over that amount which is realized upon the sale of such shares will be treated as long-term capital gain. However, to receive this special tax treatment, the employee must hold the shares for at least one year from the date of purchase and until the second anniversary of the date the purchase opportunity was granted.

#### DIRECTORS STOCK PLAN

Our Human Resources committee administers the directors stock plan. The purpose of the plan is to enable us to attract, retain and motivate the best qualified non-employee directors and to enhance a long-term aligning of interests between such directors and the holders of our common stock. Under the plan, the committee may, from time to time, grant options, Restricted Stock or Restricted Stock Units to non-employee directors. No committee member may participate in any decisions with respect to that member's benefits under the plan unless the decision applies generally to all non-employee directors.

Six months after the completion of the demutualization, all directors then in office will each receive options to purchase 2,000 shares of common stock. Directors first elected to the board of directors after the six month anniversary of the demutualization will receive an amount of options prorated with respect to the amount of time remaining until the next annual meeting of shareholders. At each annual meeting thereafter, each director then in office will receive options to purchase 2,000 shares of common stock. The exercise price shall not be less than the fair market value of the shares on the date the option is granted. Except as otherwise determined by the committee, options will become exercisable in four approximately equal installments on the third, sixth, ninth and twelfth month anniversaries of the grant date; however, no options shall become exercisable earlier than eighteen months following the completion of the demutualization. To exercise the option, payment must be made in cash, stock, through an arrangement with a broker whereby payment of the exercise price is accomplished with the proceeds of the sale of the



shares or any combination of the foregoing. We may not make a loan to a director to facilitate option exercise. Notwithstanding the foregoing, each option shall expire, if not previously exercised in accordance with the terms of the plan, on the tenth anniversary of the grant date.

If a director ceases to provide service to us, the director or, in the case of death, the director's estate or beneficiary, may exercise any option exercisable by such director at the date his or her services terminates for a period of three years, or until the tenth anniversary of the grant date of the option, whichever is earlier.

Six months after the completion of the demutualization, all directors then in office and any subsequently elected director will receive a grant of Restricted Stock Units. The number received by each director will be prorated with respect to the amount of time remaining in such director's term, so that directors whose initial term is the longest will each receive 1,500 Restricted Stock Units. Upon re-election, each director will receive 1,500 Restricted Stock Units. Restrictions on the sale or transfer of Restricted Stock Units shall lapse in substantially equal installments from the date of grant to the date of the end of such director's term, so that portions of each award vest four times per year. However, no restrictions shall lapse earlier than the eighteen months following the completion of the demutualization. In the event a director's service shall terminate, any Restricted Stock or Restricted Stock Units awarded to such director as to which the period of restriction has not lapsed shall be forfeited.

Subject to the terms and conditions of the plan, the committee may also grant options, Restricted Stock or Restricted Stock Units to any director at any time, except that: (i) no grant may be made before the six month anniversary of the completion of the demutualization; and (ii) during the 18 month period after the completion of the demutualization, the aggregate number of shares granted pursuant to such discretionary option awards shall not exceed 20,000 shares, and the aggregate number of shares granted pursuant to such discretionary Restricted Stock or Restricted Stock Unit awards shall not exceed 15,000 shares. The maximum number of shares that can be awarded under this plan is 500,000 shares of common stock, and such number is counted against the limits referred to in the second paragraph of the description of the stock incentive plan.

#### RETIREMENT PROGRAM

Principal Life maintains a qualified defined benefit retirement plan, The Principal pension plan, and a nonqualified supplemental pension plan, supplemental executive retirement plan for employees, or SERP. The SERP provides for supplemental pension benefits in excess of the benefit limits provided by the Employee Retirement Income Security Act of 1974 and benefit and compensation limits provided under the Internal Revenue Code.

The table below provides for the estimated maximum annual retirement benefits that a hypothetical participant would be entitled to receive under the combined retirement plans. These benefits are computed on a straight-life annuity basis, age 65 retirement, reduction of an annual social security benefit of \$20,028 (maximum allowed in 2001), and the number of credited years of service and average annual recognized earnings equal to the amounts indicated. A participant whose maximum credited years of service exceed 35 years upon retirement at age 65 will be entitled to benefits substantially comparable to the benefits available to a participant whose credited years of service equal 35 years upon retirement at age 65.

PENSION PLAN TABLE

REMUNERATION	YEARS OF SERVICE					
	10	15	20	25	30	35
\$300,000	\$ 49,992	\$ 74,988	\$ 99,984	\$124,980	\$149,976	\$174,972
\$350,000	59,268	88,908	118,548	148,188	177,828	207,228
\$400,000	68,556	102,840	137,124	171,408	205,680	239,964
\$450,000	77,844	116,772	155,688	194,616	233,544	272,472
\$500,000	87,132	130,692	174,264	217,836	261,408	304,968
\$550,000	96,420	144,636	192,840	241,056	289,260	337,476
\$600,000	105,708	158,556	211,416	264,264	317,124	369,972
\$650,000	114,996	172,488	229,980	287,484	344,976	402,468
\$700,000	124,272	186,420	248,556	310,692	372,828	434,976
\$750,000	133,560	200,340	267,132	333,936	400,692	467,472
\$800,000	142,848	214,272	285,696	357,120	428,544	499,968
\$850,000	152,136	228,204	304,272	380,340	456,408	532,476
\$900,000	161,424	242,136	322,836	403,548	484,260	564,972
\$950,000	170,712	256,056	341,412	426,768	512,124	597,468
\$1,000,000	179,988	269,988	359,988	449,976	539,976	629,976

The plans will provide pension benefits for Messrs. Drury, Griswell, Aschenbrenner, Gersie and Prey. "Average final compensation" under the retirement plans will be determined with respect to each executive's salary and bonus under the incentive pay plan. These amounts with respect to 2000 are shown under the "Salary" and "Bonus" columns opposite the names of these executives in the Summary Compensation Table above. The years of service with us of each of the named executives for eligibility and benefit purposes as of December 31, 2000 were as follows: David J. Drury, 34 years; J. Barry Griswell, 12 years; John E. Aschenbrenner, 28 years; Michael H. Gersie, 30 years; and Richard L. Prey, 35 years. These executives will also receive an additional benefit based on the service they earned prior to January 1, 1989.

## REGULATION

### U.S. OPERATIONS

Our business is subject to extensive regulation at both the state and federal level, including regulation under state insurance and federal and state securities laws.

#### STATE INSURANCE REGULATION

**GENERAL.** Principal Life and its insurance subsidiaries are subject to regulation and supervision by the insurance authorities in each jurisdiction in which they transact business. Currently, Principal Life is licensed to transact business in all fifty states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and seven Canadian provinces, and therefore is subject to regulation in all these jurisdictions. State insurance laws generally establish supervisory agencies with broad administrative and supervisory powers related to granting and revoking licenses, transacting business, establishing guaranty fund associations, licensing agents, approving policy forms, regulating premium rates for some lines of business, establishing reserve requirements, prescribing the form and content of required financial statements and reports, determining the reasonableness and adequacy of statutory capital and surplus and regulating the type and amount of investments permitted. State insurance departments periodically review the business and operations of an insurance company by examining its financial condition and how it conducts its business in the marketplace and how its agents sell its products. Principal Life and its insurance subsidiaries are also required to file various reports relating to their financial condition, including detailed annual and summary quarterly statutory-basis financial statements. Filings are required in each jurisdiction where Principal Life or an insurance subsidiary is licensed.

State insurance regulatory authorities and other state law enforcement agencies and attorneys general from time to time make inquiries concerning whether our insurance subsidiaries are in compliance with the regulations covering their businesses. We respond to such inquiries in a manner we deem appropriate and take corrective action if warranted.

State insurance regulators and the NAIC are continually reexamining existing laws and regulations and developing new legislation for passage by state legislatures and new regulations for adoption by insurance authorities. Proposed laws and regulations or those still underdeveloped pertain to insurer solvency and market conduct and in recent years have focused on:

- insurance company investments,
- risk-based capital guidelines, which consist of regulatory targeted surplus level based on the relationship of statutory capital and surplus, with prescribed adjustments, to the sum of stated percentages of each element of a specified list of company risk exposures,
- the implementation of non-statutory guidelines and the circumstances under which dividends may be paid,
- product approvals,
- agent licensing,
- underwriting practices, and
- insurance and annuity sales practices.

For example, the NAIC has promulgated proposed changes to statutory accounting standards. These initiatives may be adopted by the various states in which we are licensed, but the ultimate content, timing and impact of any statutes and regulations adopted by the states cannot be determined at this time.

**DIVIDENDS.** We are a holding company whose assets include all of the outstanding shares of the common stock of Principal Life. As a holding company, we will depend on dividends from our subsidiaries. The Iowa insurance laws may restrict the ability of Principal Life to pay dividends to us. Our ability to pay dividends to our stockholders and meet our obligations, including paying operating expenses and any debt service, depends upon the receipt of dividends from Principal Life. Any inability of Principal Life to pay dividends to us in the future in an amount sufficient for us to pay dividends to our stockholders and meet our other obligations may materially adversely affect our business, financial condition or results of operations.

The payment of dividends to us by Principal Life is regulated under Iowa insurance laws. Under Iowa insurance laws, Principal Life may pay dividends only out of the earned profits arising from its business. Principal Life must seek regulatory approval prior to paying a shareholder dividend or distributing cash or other property whose fair market value, together with that of other shareholder dividends or distributions made within the preceding 12 month period, exceeds the greater of:

- 10% of Principal Life's statutory surplus as of the previous calendar year end; or
- the net gain from operations of Principal Life determined on a statutory basis for the previous calendar year.



## HOLDING COMPANY REGULATION

We and our insurance subsidiaries are subject to regulation under the insurance holding company laws of various jurisdictions. The insurance holding company laws and regulations vary from jurisdiction to jurisdiction, but generally require an insurer that is a subsidiary of an insurance holding company or the insurance holding company to register with state regulatory authorities and to file with those authorities reports, including information concerning capital structure, ownership, financial condition, intercompany transactions and general business operations, including transactions involving the transfer of assets, loans or payment of dividends between an insurer and its affiliates, and in some cases to obtain prior approvals from those authorities for transactions between an insurer and its affiliates.

In addition, insurance regulators periodically examine an insurer's financial condition. Applicable state insurance laws, rather than federal bankruptcy laws, apply to the liquidation or the restructuring of insurance companies. Insurance company subsidiaries of the holding company would be subject to such state insurance laws; however, the holding company would generally be subject to federal bankruptcy laws.

## SURPLUS AND CAPITAL REQUIREMENTS

Insurance regulators have the discretionary authority, in connection with the ongoing licensing of our insurance subsidiaries, to limit or prohibit the ability to issue new policies if, in the regulators' judgment, the insurer is not maintaining a minimum amount of surplus or is in hazardous financial condition. Limits may also be established on the ability to issue new life insurance policies and annuity contracts above an amount based upon the face amount and premiums of policies of a similar type issued in the prior year. We do not believe that the current or anticipated levels of statutory surplus of Principal Life present a material risk that any such regulator would limit the amount of new insurance business Principal Life may issue. Statutory surplus is the excess of admitted assets over statutory liabilities, as shown on Principal Life's statutory financial statements.

## RISK-BASED CAPITAL

The NAIC has established risk-based capital standards for life insurance companies as well as a model act to apply such standards at the state level. The model act provides that life insurance companies must submit an annual risk-based capital report to state regulators reporting their risk-based capital based on four categories of risk: asset risk, insurance risk, interest rate risk and business risk. For each category, the capital requirement is determined by applying factors to various asset, premium and reserve items, with the factor being higher for those items with greater underlying risk and lower for less risky items. The formula is intended to be used by insurance regulators as an early warning tool to identify possible weakly capitalized companies for purposes of initiating further regulatory action.

If an insurer's total adjusted capital falls below specified levels, the insurer would be subject to different degrees of regulatory action depending upon the level. These actions range from requiring the insurer to propose actions to correct the capital deficiency to placing the insurer under regulatory control. At June 30, 2001, Principal Life's total adjusted capital exceeded the level of risk-based capital that would require it to take any corrective action.

## GUARANTY FUNDS

All fifty states of the United States, the District of Columbia and Puerto Rico have insurance laws requiring companies licensed to do life or health insurance business within those jurisdictions to participate as members of the state's life and health insurance guaranty associations. These associations are organized to pay contractual obligations under life and health insurance policies and annuity contracts issued by impaired or insolvent insurance companies. To meet these obligations, these associations levy assessments on all member insurers based on the proportionate share of the premiums written by each member in the lines of business in which the impaired or insolvent insurer is engaged. Some states permit member insurers to recover assessments paid through full or partial premium tax offsets, usually over a period of years. For the six months ended June 30, 2001, and the years ended December 31, 2000, 1999, and 1998, we paid \$0.2 million, \$0.1 million, \$2.2 million, and \$6.5 million, respectively, in assessments, net of returns, made under state guaranty association laws. While the amount of future assessments cannot be accurately predicted, we believe that assessments with respect to other pending insurance company impairments and insolvencies will not be material to our business, financial condition or results of operations.

## STATUTORY INVESTMENT VALUATION RESERVES

Life insurance companies are required to establish an asset valuation reserve to stabilize statutory policyholder surplus from fluctuations in the market value of and/or realized gains or losses on bonds, stocks, mortgage loans, real estate and other invested assets, other than fluctuations captured by the INTEREST MAINTENANCE RESERVE. Although

classified as a reserve account, asset valuation reserve does not represent an obligation of the company. Asset valuation reserve has two components:

- a "default component," which provides for future credit-related losses on fixed maturity investments; and
- an "equity component," which provides for losses on all types of equity investments, including equity securities and real estate.

Asset valuation reserve generally captures all realized and unrealized gains or losses on invested assets, other than those resulting from changes in interest rates. Each year the amount of an insurer's asset valuation reserve will fluctuate as additional gains or losses are absorbed by the reserve. To adjust for such changes over time, an annual contribution must be made to the asset valuation reserve equal to a basic contribution plus 20% of the difference between the reserve objective and the actual asset valuation reserve. Insurers also are required to establish an Interest Maintenance Reserve for net realized capital gains and losses on fixed maturity securities, net of tax, related to changes in interest rates. The Interest Maintenance Reserve applies to all types of fixed maturity investments, including bonds, preferred stocks, mortgage-backed securities and mortgage loans. The Interest Maintenance Reserve is required to be amortized into statutory earnings on a basis reflecting the remaining period to maturity of the fixed maturity securities sold. These reserves are required by state insurance regulatory authorities to be established as a liability on a life insurer's statutory financial statements, but do not affect our financial statements prepared in accordance with GAAP. Although future additions to asset valuation reserve will reduce Principal Life's future statutory capital and surplus, we do not believe that the impact under current regulations of such reserve requirements will materially affect the ability of Principal Life to increase its statutory capital and surplus and pay future dividends to us.

#### NAIC INSURANCE REGULATORY INFORMATION SYSTEM RATIOS

The NAIC has developed a set of financial tests known as the Insurance Regulatory Information System for early identification of companies which may require special attention by insurance regulators. Insurance companies submit data on an annual basis to the NAIC. These data are used to calculate ratios covering various categories of financial data, with defined "usual ranges" for each category. The Insurance Regulatory Information System consists of 12 key financial ratios for life insurance companies. Departure from the usual range on four or more of the ratios may lead to inquiries from individual states' insurance departments. For the year ended December 31, 2000, Principal Life was within the "usual range" for all of the ratios.

#### REGULATION OF INVESTMENTS

Our insurance subsidiaries are subject to state laws and regulations that require diversification of their investment portfolios. Some of these laws and regulations also limit the amount of investments in specified investment categories, such as below investment grade fixed maturity securities, equity real estate, other equity investments and derivatives. Failure to comply with these laws and regulations would cause investments exceeding regulatory limitations to be treated as non-admitted assets for purposes of measuring statutory surplus, in some instances, requiring divestiture. Non-admitted assets are assets or portions of those assets which are not permitted to be reported as admitted assets in an insurance company's annual statement. As a result, assets which normally would be accorded value in the financial statements of non-insurance companies are accorded no value and thus reduce the reported statutory policyholder surplus of the insurance company. State regulatory authorities from the domiciliary states of our insurance subsidiaries have not indicated any non-compliance with any such regulations.

#### VALUATION OF LIFE INSURANCE POLICIES MODEL REGULATION

The NAIC has adopted a revision to the Valuation of Life Insurance Policies Model Regulation, known as Revised XXX, which Iowa adopted effective January 1, 2000. This regulation establishes new minimum statutory reserve requirements for some individual life insurance policies written in the future. Under this regulation, companies selling specified individual life insurance products, such as term life insurance with guaranteed premium periods and universal life insurance products with no-lapse guarantees, are required to redesign their products or hold increased reserves to be consistent with the new minimum standards with respect to policies issued after the effective date of the regulation. Principal Life has taken action to either redesign or increase reserves with respect to these products, and we do not believe these actions will result in a material adverse effect on our business, financial condition or results of operations.

#### STATUTORY EXAMINATION

As part of their routine regulatory oversight process, state insurance departments conduct periodic detailed examinations of the books, records and accounts of insurers domiciled in their states. These examinations are generally conducted in cooperation with the departments of two or three other states under guidelines promulgated by the NAIC. On August 21, 2000, the Iowa insurance division completed an examination of Principal Life for the three-year period ended December 31, 1998. No material violations of law were found.

State insurance departments also periodically conduct market conduct examinations of the sales practices of insurance companies, including our life insurance subsidiaries. In recent years, a number of life and annuity insurers have been the subject of regulatory proceedings and litigation relating to alleged improper life insurance pricing and sales practices. Some of these insurers have incurred or paid substantial amounts in connection with the resolution of such matters. Regulatory authorities in a small number of states, including both insurance departments and attorneys general, have ongoing investigations of our sales of individual life insurance policies or annuities, including investigations of alleged improper replacement transactions and alleged improper sales of insurance with inaccurate or inadequate disclosures as to the period for which premiums would be payable.

#### REGULATION OF SAVINGS AND LOAN HOLDING COMPANY

Due to our indirect control of Principal Bank, a federal savings bank, we are a savings and loan holding company regulated by the Office of Thrift Supervision; however, since we control only one savings bank, our activities are not subject to all of the limitations on business activities otherwise applicable to savings and loan holding companies.

#### FEDERAL INSURANCE INITIATIVES

Although the federal government generally does not directly regulate the insurance business, federal initiatives often have an impact on our business. Current and proposed measures that may significantly affect the insurance business generally include limitations on anti-trust immunity, minimum solvency requirements and health care reform.

Congressional committees have held hearings with respect to the optional federal chartering and regulation of insurance companies and agencies. Although no legislative bills have yet been introduced, there are currently proposals made by insurance and banking trade associations providing for uniform federal regulation of the insurance industry. We cannot predict what other proposals may be made in connection with the federal chartering, what legislation, if any, may be introduced or enacted and what effect any such legislation may have on us.

On November 21, 2000, the Department of Labor issued new regulations to create a rapid process for employees to appeal claims rejected by their health insurance plans. The new regulations apply to all claims filed on or after January 1, 2002.

On November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act of 1999, implementing fundamental changes in the regulation of the financial services industry in the United States. The act permits the transformation of the already converging banking, insurance and securities industries by permitting mergers that combine commercial banks, insurers and securities firms under one holding company. Under the act, national banks retain their existing ability to sell insurance products in some circumstances. In addition, bank holding companies that qualify and elect to be treated as "financial holding companies" may engage in activities, and acquire companies engaged in activities, that are "financial" in nature or "incidental" or "complementary" to such financial activities, including acting as principal, agent or broker in selling life, property and casualty and other forms of insurance, including annuities. A financial holding company can own any kind of insurance company or insurance broker or agent, but its bank subsidiary cannot own the insurance company. Under state law, the financial holding company would need to apply to the insurance commissioner in the insurer's state of domicile for prior approval of the acquisition of the insurer, and the act provides that the commissioner, in considering the application, may not discriminate against the financial holding company because it is affiliated with a bank. Under the act, no state may prevent or interfere with affiliations between banks and insurers, insurance agents or brokers, or the licensing of a bank or affiliate as an insurer or agent or broker.

Until passage of the Gramm-Leach-Bliley Act, the Glass-Steagall Act of 1933 had limited the ability of banks to engage in securities-related businesses, and the Bank Holding Company Act of 1956 had restricted banks from being affiliated with insurance companies. With the passage of the Gramm-Leach-Bliley Act, bank holding companies may acquire insurers, and insurance holding companies may acquire banks. The ability of banks to affiliate with insurance companies may materially adversely affect all of our product lines by substantially increasing the number, size and financial strength of potential competitors.

#### TAX LEGISLATION

Currently, the Internal Revenue Code provides favorable federal income tax treatment to holders of various types of life insurance and annuity products. For example, increases in the cash value of life insurance and annuity products are tax-deferred during the product's accumulation period and life insurance death benefits paid to the beneficiary after the insured's death are generally not subject to federal income taxation. Withdrawals from life insurance and annuity products also receive generally favorable tax treatment. In addition, interest, within limitations, on loans up to \$50,000 secured by the cash value of life insurance policies owned by businesses on key employees is eligible for deduction even though investment earnings during the accumulation period are tax-deferred. Congress has on occasion considered proposals to reduce or eliminate the favorable tax rules for life insurance and annuity contracts. If such proposals are ever adopted, they could substantially reduce market demand for these products.

The Economic Growth and Tax Relief Reconciliation Act of 2001 contains a number of changes in the federal estate tax. Among other things, it (1) increases the amount of the unified credit, thereby increasing the amount of property not subject to the estate tax, and (2) gradually reduces the federal estate tax rate over a period of years beginning in 2002 and repeals it entirely for the year 2010. The law in effect prior to the Act, however, is reinstated for years after 2010. Many insurance products are designed and marketed for the purpose of reducing the federal estate tax. Although the impact of this new law on insurance companies is not yet clear, it is quite possible that it could result in a significant reduction in sales of our insurance products.

#### SECURITIES LAWS

Our investment advisory activities are subject to federal and state securities laws and regulations. Our mutual funds are registered under the Investment Company Act of 1940. The shares issued by the mutual funds are registered under the Securities Act. Additionally, two of our separate investment accounts fund variable annuity contracts and variable life insurance policies we issue are registered under the Investment Company Act. Some of the variable annuity contracts and variable life insurance policies we issue are registered under the Securities Act. Two of our subsidiaries are registered as broker/dealers under the Exchange Act, and are members of the National Association of Securities Dealers, Inc. A number of our subsidiaries are registered as investment advisers under the Investment Advisers Act of 1940. We are also subject to similar laws and regulations in the states and foreign countries in which we provide investment advisory services, offer the products described above or non-variable life and annuity products or conduct other securities and investment related activities.

#### PRIVACY OF CUSTOMER INFORMATION

Federal law and regulation requires financial institutions to protect the security and confidentiality of customer information and to notify customers about their policies and practices relating to their collection and disclosure of customer information and their policies relating to protecting the security and confidentiality of that information. Federal and state laws also regulate disclosures of customer information. Congress and state legislatures are expected to consider additional regulation relating to privacy and other aspects of customer information.

#### ENVIRONMENTAL CONSIDERATIONS

As owner and operator of real property, we are subject to extensive federal, state and local environmental laws and regulations. Inherent in such ownership and operation is the risk that there may be potential environmental liabilities and costs in connection with any required remediation of such properties. When deemed appropriate, we routinely conduct environmental assessments for real estate being acquired for investment and before taking title to property acquired through foreclosure or deed in lieu of foreclosure. Based on these environmental assessments and compliance with our internal environmental procedures, we believe that any costs associated with compliance with environmental laws and regulations or any remediation of such properties would not be material to our consolidated financial position. Furthermore, although we hold equity positions in subsidiaries and investments that could potentially be subject to environmental liabilities, we believe that we would not be subject to any environmental liabilities with respect to these investments which would have a material adverse effect on our business, financial position or results of operations.

#### ERISA CONSIDERATIONS

We engage in several lines of business, including our management of employee benefit plan assets held in our separate accounts that are subject to the requirements of ERISA. The Small Business Job Protection Act offered insurers some protection from potential litigation exposure prompted by the 1993 U.S. Supreme Court decision in *John Hancock Mutual Life Insurance Company v. Harris Trust & Savings Bank*. In *Harris Trust*, the Court held that, with respect to a portion of the funds held under general account group annuity contracts, an insurer is subject to the fiduciary requirements of ERISA under some circumstances. The pertinent provisions of the Small Business Job Protection Act provide that insurers are protected from liability for prohibited transactions and for breaches of fiduciary duties under ERISA for past actions with respect to their general account contracts. However, insurers remain subject to federal criminal law and liable for actions brought by the U.S. Secretary of Labor alleging breaches of fiduciary duties that also constitute a violation of federal or state criminal law.

The Small Business Job Protection Act also provides that contracts issued from an insurer's general account on or before December 31, 1998, that are not guaranteed benefit policies, will not subject an insurer's general account to ERISA's fiduciary requirements if they meet the requirements of regulations to be issued by the United States Department of Labor. Contracts issued from an insurer's general account after December 31, 1998, that are not guaranteed benefit policies will potentially subject the insurer's general account to ERISA. On January 5, 2000, the Department of Labor published regulations under the Small Business Job Protection Act which provide, among other things, that if an employee benefit plan acquired an insurance policy, other than a guaranteed benefit policy, issued on or before December 31, 1998 that is supported by the assets of the insurer's general account, the plan's assets for purposes of ERISA will not be deemed to include any of the assets of the insurer's general account, provided that the

requirements of the regulation are met. Accordingly, if those requirements are met, the insurer would not be subject to the fiduciary obligations of ERISA as a result of issuing such an insurance policy. These requirements include detailed disclosures to be made to the employee benefit plan and the requirement that the insurer must permit the policyholder to terminate the policy on 90 days' notice and receive without penalty, at the policyholder's option, either: (1) the accumulated fund balance, which may be subject to market value adjustment; or (2) a book value payment of such amount in annual installments with interest. In the event we elect to comply with the requirements to secure the exemption provided by the regulations from the fiduciary obligations of ERISA, our exposure to disintermediation risk could increase due to the termination options that we would be required to provide to policyholders. In the absence of relief under the regulations, the Harris Trust decision could substantially increase administrative costs, may require the segregation of assets currently in the general account, result in potential liability arising from the application of ERISA's fiduciary rules to our general account or adversely affect future business.

With respect to employee welfare benefit plans subject to ERISA, the Congress periodically has considered amendments to the law's federal preemption provision, which would expose us, and the insurance industry generally, to state law causes of action, and accompanying extra-contractual damages, such as punitive damages, in lawsuits involving, for example, group life and group disability claims. To date, all such amendments to ERISA have been defeated.

#### INTERNATIONAL OPERATIONS

##### BT FINANCIAL GROUP

The Australian Securities and Investments Commission is the primary regulator of the Australian securities industry. The Australian Prudential Regulatory Authority is primarily responsible for the regulation of superannuation and life insurance product providers.

A number of BT Financial Group companies hold securities licenses. Several BT Financial Group companies have been approved by the Australian Prudential Regulatory Authority to act as trustees for superannuation products. BT Tactical Asset Management Pty Limited holds a futures brokers license and is a member of the Sydney Futures Exchange. BT Life Limited is registered as a life company under the Life Insurance Act. BT Securities Limited is registered as a financial corporation under the Financial Corporations Act. BT Financial Group companies are also subject to various regulations in foreign jurisdictions in which they operate.

Australia's risk-based capital adequacy guidelines are generally consistent with the approach agreed upon by the Bank Committee on Banking Regulation and Supervisory Practices (Bank for International Settlements).

##### PRINCIPAL INTERNATIONAL

Principal International operates in a number of countries around the world. The degree of regulation and supervision of our businesses varies from minimal in some countries to stringent in others.

Generally, we and those of our subsidiaries conducting business internationally must obtain licenses from local authorities and satisfy local regulatory requirements. The licenses local authorities issue to us and our subsidiaries are subject to modification and revocation by such authorities and, thus, we and our subsidiaries could be prevented from conducting business in jurisdictions where we currently operate.

Local authorities also regulate our international asset accumulation operations by imposing requirements relating to currency, policy language and terms, amount and type of security deposits, amount and type of reserves, amount and type of local investment and the share of profits that must be returned to policyholders on participating policies. Some local authorities regulate rates on various types of policies. Certain countries have established reinsurance institutions, wholly or partially owned by the state, to which admitted insurers are obligated to cede portion of their business on terms which do not always allow foreign insurers, including us, for compensation. In some countries, regulations governing constitution of technical reserves and remittance balances may hinder remittance of profits and repatriation of assets.

ARGENTINA. In Argentina, the National Insurance Superintendence regulates our insurance and annuity operations, including by restricting the types of entities that may engage in the insurance business. The National Insurance Superintendence, at its sole discretion, may award or reject authorizations for the formation of a new insurance company and requires notice of any transfers of shares of previously authorized insurance companies. Insurance companies are subject to reporting requirements which mandate the filing of, among other things, copies of resolutions passed at shareholders' meetings, financial statements and statistical information relating to the types of insurance sold and geographical distribution of such sales.

BRAZIL. The National Council of Private Insurance is responsible for adopting policies, rules and regulations governing private pension companies in Brazil. The Superintendent of Private Insurance is responsible for the audit/review of the activities of private pension companies, including accounting, actuarial and statistical audits/reviews, and for authorizing the establishment and operations of these companies. All products sold by private

pension companies must be approved by the Superintendent of Private Insurance. Our private pension company, BrasilPrev Previdencia Privada S.A., has been authorized to operate through a license granted by the Superintendent of Private Insurance, as well as previous authorization from the Superintendent of Private Insurance to administer all the products that BrasilPrev currently sells.

CHILE. The Superintendent of Securities and Insurance is the regulator responsible for supervising all insurance company activities in Chile. The investments of insurance companies are highly regulated. The Superintendent of Securities and Insurance has established limits with respect to equity and leverage ratios for insurance company investments. Compliance with these limits is regularly monitored.

HONG KONG. As a long term life insurance provider, Principal Insurance Company (Hong Kong) Limited is regulated by the Hong Kong Insurance Authority and its investment products are regulated by the Hong Kong Securities & Futures Commission, which is also responsible for overseeing its pension operations. The Insurance Authority requires that, so long as Principal Insurance Company (Hong Kong) Limited holds an insurance license, it must maintain a minimum capital of HK\$300 million and a solvency margin in respect of each particular product it is underwriting. Mandatory Provident Fund Schemes must be under a trust. As such, Principal Trust Company (Asia) Limited, the trustee of all Mandatory Provident Fund Schemes, along with the delegated administrator Principal Insurance Company (Hong Kong) Limited and its investment manager Principal Asset Management Company (Asia) Limited, are regulated by the Mandatory Provident Fund Schemes Authority.

INDIA. In India, the Securities and Exchange Board of India supervises the registration, regulation and working of collective investment schemes including mutual funds. Indian law governs the structure of a mutual fund, the rights, duties and obligations of sponsors, the trustees, the asset management company, the custodian, the registrar, investment guidelines/limits and valuation policies, advertisement and marketing code, accounting policies and standards, code of conduct and disclosure requirements.

MEXICO. The Ministry of Treasury is responsible for oversight of the insurance industry in Mexico, but it is handled through the National Insurance and Bonding Commission. All claims against insurance companies are handled through the National Commission for the Rights of the Financial Services Users.

The National Commission for the Retirement Savings System supervises the private pension fund managers who administer Mexico's pension system, and the pension funds, they manage. As of March 31, 2001, each pension fund manager must keep an initial minimum capital requirement of 25.0 million pesos (\$2.8 million) in reserve in order to operate and each private pension fund must have initial capital of 4.0 million pesos (\$0.4 million). In order to prevent any pension fund manager from gaining control of the market, no pension fund manager is permitted to manage assets for more than 17 percent of the number of individuals in the mandatory privatized social security system in the first four years after the public pension system begins. Thereafter, a pension fund manager's market share is limited to 20 percent.

OWNERSHIP OF COMMON STOCK

The following table presents selected information regarding the beneficial ownership of our common stock as of the effective date of the demutualization by:

- (1) each of our directors and named executive officers; and
- (2) all of our directors and executive officers as a group.

The number of shares of our common stock beneficially owned by each director and executive officer and all directors and executive officers as a group is based upon the number of shares that we estimate each director and executive officer, and persons and entities affiliated with each director and executive officer, will receive in their capacity as policyholders entitled to receive compensation in the demutualization. Except as otherwise indicated below, each of the persons named in the table will have sole voting and investment power with respect to the shares beneficially owned by such person as indicated opposite such person's name.

NAME -----	NUMBER OF SHARES TO BE BENEFICIALLY OWNED(1) -----
David J. Drury.....	*
J. Barry Griswell.....	*
Betsy J. Bernard.....	*
Jocelyn Carter-Miller.....	*
Daniel Gelatt.....	*
Sandra L. Helton.....	*
Charles S. Johnson.....	*
William T. Kerr.....	*
Lee Liu.....	*
Victor H. Loewenstein.....	*
Ronald D. Pearson.....	*
Federico F. Pena.....	*
Donald M. Stewart.....	*
Elizabeth E. Tallett.....	*
John E. Aschenbrenner.....	*
Michael T. Daley.....	*
Dennis P. Francis.....	*
Michael H. Gersie.....	*
Ellen Z. Lamale.....	*
Mary A. O'Keefe.....	*
Richard L. Prey.....	*
Karen E. Shaff.....	*
Norman R. Sorensen.....	*
Carl C. Williams.....	*
Larry D. Zimpleman.....	*
All directors and executive officers as a group (25 persons).....	*

\* Less than 1% of the number of shares of our common stock expected to be outstanding on the effective date of the demutualization.

(1) Based on an estimated allocation of shares based upon policy ownership records as of June 30, 2001.

We believe no person will beneficially own more than 5% of our outstanding shares of common stock as of the effective date of the demutualization. The independent fiduciary for the shares of our common stock issued to a new separate account of Principal Life as part of the Separate Account Policy Credits may from time to time share beneficial ownership over those shares because it will, if the matter involved is not routine, instruct Principal Life to vote the shares as to which Principal Life has received no instruction from the Qualified Plan Customers. See "The Demutualization -- Operation of the Separate Account Holding Shares of our Common Stock."

DESCRIPTION OF CAPITAL STOCK AND CHANGE OF CONTROL  
RELATED PROVISIONS

The authorized capital stock of Principal Financial Group, Inc. consists of 2.5 billion shares of common stock and 500 million shares of preferred stock.

#### COMMON STOCK

Holder of common stock are entitled to receive such dividends as may from time to time be declared by our board of directors out of funds legally available for the payment of such dividends. See "Stockholder Dividend Policy". Holders of common stock are entitled to one vote per share on all matters on which the holders of common stock are entitled to vote and do not have any cumulative voting rights. Holders of common stock have no preemptive, conversion, redemption or sinking fund rights. In the event of a liquidation, dissolution or winding up of Principal Financial Group, Inc., holders of common stock are entitled to share equally and ratably in the assets of Principal Financial Group, Inc., if any, remaining after the payment of all liabilities of Principal Financial Group, Inc. and the liquidation preference of any outstanding class or series of preferred stock. The outstanding shares of common stock are, and the shares of common stock offered by Principal Financial Group, Inc. in this offering, when issued, will be, fully paid and nonassessable. The rights and privileges of holders of common stock are subject to any series of preferred stock that Principal Financial Group, Inc. may issue in the future, as described below.

#### PREFERRED STOCK

Our board of directors has the authority to issue preferred stock in one or more series and to fix the number of shares constituting any such series and the voting rights, designations, preferences and qualifications, limitations and restrictions of the shares constituting any series, without any further vote or action by our stockholders. The issuance of preferred stock by our board of directors could adversely affect the rights of holders of common stock.

We will authorize shares of Series A Junior Participating Preferred Stock in connection with our stockholder rights plan. See "-- Stockholder Rights Plan".

#### CHANGE OF CONTROL RELATED PROVISIONS IN OUR CERTIFICATE OF INCORPORATION AND BY-LAWS, AND DELAWARE LAW

A number of provisions of our certificate of incorporation and by-laws deal with matters of corporate governance and rights of stockholders. The following discussion is a general summary of selected provisions of our certificate of incorporation and by-laws and regulatory provisions that might be deemed to have a potential antitakeover effect. See "Risk Factors -- Applicable laws and our stockholder rights plan, certificate of incorporation and by-laws may discourage takeovers and business combinations that our stockholders might consider in their best interests". These provisions may have the effect of discouraging a future takeover attempt which is not approved by our board of directors but which individual stockholders may deem to be in their best interests or in which stockholders may receive a substantial premium for their shares over then current market prices. As a result, stockholders who might desire to participate in such a transaction may not have an opportunity to do so. Such provisions will also render the removal of the incumbent board of directors or management more difficult. Some provisions of the Delaware General Corporation Law and the Iowa Insurance Law may also have an antitakeover effect. The following description of selected provisions of our certificate of incorporation and bylaws and selected provisions of the Delaware General Corporation Law and the Iowa Insurance Law are necessarily general and reference should be made in each case to our certificate of incorporation and by-laws, which are filed as exhibits to our registration statement, and to the provisions of those laws. See "Additional Information" for information on where to obtain a copy of our certificate of incorporation and by-laws.

#### UNISSUED SHARES OF CAPITAL STOCK

**COMMON STOCK.** Based upon the assumptions described under "Unaudited Pro Forma Condensed Consolidated Financial Information," we currently plan to issue an estimated 360.6 million shares of our authorized common stock in this offering and the demutualization. The remaining shares of authorized and unissued common stock will be available for future issuance without additional stockholder approval. While the additional shares are not designed to deter or prevent a change of control, under some circumstances we could use the additional shares to create voting impediments or to frustrate persons seeking to effect a takeover or otherwise gain control by, for example, issuing those shares in private placements to purchasers who might side with our board of directors in opposing a hostile takeover bid.

**PREFERRED STOCK.** Our board of directors has the authority to issue preferred stock in one or more series and to fix the number of shares constituting any such series and the preferences, limitations and relative rights, including dividend rights, dividend rate, voting rights, terms of redemption, redemption price or prices, conversion rights and liquidation preferences of the shares constituting any series, without any further vote or action by our stockholders. The existence of authorized but unissued preferred stock could reduce our attractiveness as a target for an unsolicited takeover bid since we could, for example, issue shares of preferred stock to parties who might oppose such a takeover bid or shares that contain terms the potential acquiror may find unattractive. This may have the effect of delaying or



preventing a change in control, may discourage bids for the common stock at a premium over the market price of the common stock, and may adversely affect the market price of, and the voting and other rights of the holders of, common stock.

**CLASSIFIED BOARD OF DIRECTORS AND REMOVAL OF DIRECTORS.** Our certificate of incorporation provides that the directors shall be divided into three classes, as nearly equal in number as possible, with the term of office of each class to be three years. The classes serve staggered terms, such that the term of one class of directors expires each year. Any effort to obtain control of our board of directors by causing the election of a majority of the board of directors may require more time than would be required without a staggered election structure. Our certificate of incorporation also provides that directors may be removed only for cause at a meeting of stockholders by a vote of a majority of the shares then entitled to vote. This provision may have the effect of slowing or impeding a change in membership of our board of directors that would effect a change of control.

**RESTRICTION ON MAXIMUM NUMBER OF DIRECTORS AND FILLING OF VACANCIES ON OUR BOARD OF DIRECTORS.** Our by-laws provide that the number of directors shall be fixed and increased or decreased from time to time by resolution of the board of directors, but the board of directors shall at no time consist of fewer than three directors. Stockholders can only remove a director for cause by a vote of a majority of the shares entitled to vote, in which case the vacancy caused by such removal may be filled at such meeting by the stockholders entitled to vote for the election of the director so removed. Any vacancy on the board of directors, including a vacancy resulting from an increase in the number of directors or resulting from a removal for cause where the stockholders have not filled the vacancy, may be filled by a majority of the directors then in office, although less than a quorum. If the vacancy is not so filled, it shall be filled by the stockholders at the next annual meeting of stockholders. The stockholders are not permitted to fill vacancies between annual meetings except where the vacancy resulted from a removal for cause. These provisions give incumbent directors significant authority that may have the effect of limiting the ability of stockholders to effect a change in management.

**ADVANCE NOTICE REQUIREMENTS FOR NOMINATION OF DIRECTORS AND PRESENTATION OF NEW BUSINESS AT MEETINGS OF STOCKHOLDERS; ACTION BY WRITTEN CONSENT.** Our by-laws provide for advance notice requirements for stockholder proposals and nominations for director. In addition, under the provisions of both our certificate of incorporation and by-laws, action may not be taken by written consent of stockholders; rather, any action taken by the stockholders must be effected at a duly called meeting. The chief executive officer, or, under some circumstances, the president or any vice president, and the board of directors may call a special meeting. These provisions make it more procedurally difficult for a stockholder to place a proposal or nomination on the meeting agenda or to take action without a meeting, and therefore may reduce the likelihood that a stockholder will seek to take independent action to replace directors or seek a stockholder vote with respect to other matters that are not supported by management.

#### LIMITATIONS ON DIRECTOR LIABILITY

Our certificate of incorporation contains a provision that is designed to limit our directors' liability. Specifically, directors will not be held liable to Principal Financial Group, Inc. for monetary damages for breach of their fiduciary duty as a director, except to the extent that this limitation on or exemption from liability is not permitted by the Delaware General Corporation Law and any amendments to that law.

The principal effect of the limitation on liability provision is that a stockholder is unable to prosecute an action for monetary damages against a director of Principal Financial Group, Inc. unless the stockholder can demonstrate a basis for liability for which indemnification is not available under the Delaware General Corporation Law. This provision, however, does not eliminate or limit director liability arising in connection with causes of action brought under the federal securities laws. Our certificate of incorporation does not eliminate our directors' duty of care. The inclusion of this provision in our certificate of incorporation may, however, discourage or deter stockholders or management from bringing a lawsuit against directors for a breach of their fiduciary duties, even though such an action, if successful, might otherwise have benefited Principal Financial Group, Inc. and our stockholders. This provision should not affect the availability of equitable remedies such as injunction or rescission based upon a director's breach of the duty of care.

Our by-laws also provide that we will indemnify our directors and officers to the fullest extent permitted by Delaware law. We are required to indemnify our directors and officers for all judgments, fines, settlements, legal fees and other expenses incurred in connection with pending or threatened legal proceedings because of the director's or officer's position with Principal Financial Group, Inc. or another entity that the director or officer serves at our request, subject to various conditions, and to advance funds to our directors and officers to enable them to defend against such proceedings. To receive indemnification, the director or officer must have been successful in the legal proceeding or have acted in good faith and in what was reasonably believed to be a lawful manner in the best interest of Principal Financial Group, Inc.

**SUPERMAJORITY VOTING REQUIREMENT FOR AMENDMENT OF CERTAIN PROVISIONS OF OUR CERTIFICATE OF INCORPORATION AND BY-LAWS.** The provisions of our certificate of incorporation governing, among other things the classified board, the director's discretion in determining what he or she reasonably believes to be in the best interests of Principal Financial



Group, Inc., the liability of directors and the elimination of stockholder actions by written consent may not be amended, altered or repealed unless the amendment is approved by the vote of holders of three-fourths of the shares then entitled to vote at an election of directors. This requirement exceeds the majority vote of the outstanding stock that would otherwise be required by the Delaware General Corporation Law for the repeal or amendment of such provisions of the certificate of incorporation. Our by-laws may be amended by the board of directors or by the vote of holders of three-fourths of the shares then entitled to vote. These provisions make it more difficult for any person to remove or amend any provisions that have an antitakeover effect.

**BUSINESS COMBINATION STATUTE.** In addition, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law, unless we elect in our certificate of incorporation not to be governed by the provisions of Section 203. We have not made that election. Section 203 can affect the ability of an "interested stockholder" of Principal Financial Group, Inc. to engage in business combinations, such as mergers, consolidations or acquisitions of additional shares of Principal Financial Group, Inc., for a period of three years following the time that the stockholder becomes an "interested stockholder." An "interested stockholder" is defined to include persons owning directly or indirectly 15% or more of the outstanding voting stock of a corporation. The provisions of Section 203 are not applicable in some circumstances, including those in which (a) the business combination or transaction which results in the stockholder becoming an "interested stockholder" is approved by the corporation's board of directors prior to the time the stockholder becomes an "interested stockholder" or (b) the "interested stockholder," upon consummation of such transaction, owns at least 85% of the voting stock of the corporation outstanding prior to such transaction.

#### LIMITATIONS ON ACQUISITIONS OF SECURITIES

Iowa law prohibits for a period of 5 years following the date of distribution of consideration to the policyholders in exchange for their membership interests:

- any person, other than the reorganized company, or other than an employee benefit plan or employee benefit trust sponsored by the reorganized company from, directly or indirectly, acquiring or offering to acquire the beneficial ownership of more than 5% of any class of voting security of the reorganized company, and
- any person, other than the reorganized company, or other than an employee benefit plan or employee benefit trust sponsored by the reorganized company, who acquires 5% or more of any class of voting security of the reorganized company prior to the conversion from, directly or indirectly, acquiring or offering to acquire the beneficial ownership of additional voting securities of the reorganized company,

unless the acquisition is approved by the Insurance Commissioner of the State of Iowa and by the board of directors of the reorganized company.

By virtue of these provisions, we may not be subject to an acquisition by another company during the 5 years following the distribution of consideration to Principal Life's policyholders entitled to receive compensation in the demutualization.

The insurance holding company and other insurance laws of many states also regulate changes of control of insurance holding companies, such as Principal Financial Group, Inc. A change of control is generally presumed upon acquisitions of 10% or more of voting securities. The Iowa, Arizona and Vermont insurance holding company laws, which we expect to be applicable to us following the demutualization, require filings in connection with proposed acquisitions of control of domestic insurance companies. These insurance holding company laws prohibit a person from acquiring direct or indirect control of an insurer incorporated in the relevant jurisdiction without prior insurance regulatory approval.

#### STOCKHOLDER RIGHTS PLAN

Our board of directors has adopted a stockholder rights plan under which each outstanding share of our common stock issued between the date on which Principal Financial Group, Inc. enters into the underwriting agreement for the initial public offering and the distribution date (as described below) will be coupled with a stockholder right. Initially, the stockholder rights will be attached to the certificates representing outstanding shares of common stock, and no separate rights certificates will be distributed. Each right will entitle the holder to purchase one one-thousandth of a share of our Series A Junior Participating Preferred Stock. Each one one-thousandth of a share of Series A Junior Participating Preferred Stock will have economic and voting terms equivalent to one share of Principal Financial Group, Inc.'s common stock. Until it is exercised, the right itself will not entitle the holder of the right to any rights as a stockholder, including the right to receive dividends or to vote at stockholder meetings. The description and terms of the rights are found in a rights agreement entered into between Principal Financial Group, Inc. and Mellon Investor Services LLC, as rights agent. Although the material provisions of the rights agreement have been accurately summarized, the statements below concerning the rights agreement are not necessarily complete, and in each instance reference is made to the form of rights agreement itself, a copy of which has been filed as an exhibit to the

Registration Statement of which this prospectus forms a part. Each statement is qualified in its entirety by such reference.

Stockholder rights are not exercisable until the distribution date and will expire at the close of business on the tenth anniversary of the date on which the initial public offering price is determined, unless earlier redeemed or exchanged by us. A distribution date would occur upon the earlier of:

- the tenth day after the first public announcement or communication to us that a person or group of affiliated or associated persons (referred to as an acquiring person) has acquired beneficial ownership of 10% or more of our outstanding common stock (the date of such announcement or communication is referred to as the stock acquisition time); or
- the tenth business day after the commencement or announcement of the intention to commence a tender offer or exchange offer that would result in a person or group becoming an acquiring person.

If any person becomes an acquiring person, each holder of a stockholder right will be entitled to exercise the right and receive, instead of Series A Junior Participating Preferred Stock, common stock or, in some circumstances, cash, a reduction in purchase price, property or other securities of Principal Financial Group, Inc., having a value equal to two times the purchase price of the stockholder right. All stockholder rights that are beneficially owned by an acquiring person or its transferee will become null and void.

If at any time after a public announcement has been made or Principal Financial Group, Inc. has received notice that a person has become an acquiring person:

- Principal Financial Group, Inc. is acquired in a merger or other business combination, or
- 50% or more of Principal Financial Group, Inc.'s assets, cash flow or earning power is sold or transferred,

each holder of a stockholder right, except rights which previously have been voided as described above, will have the right to receive, upon exercise, common stock of the acquiring company having a value equal to two times the purchase price of the right.

The purchase price payable, the number of one one-thousandth of a share of Series A Junior Participating Preferred Stock or other securities or property issuable upon exercise of stockholder rights and the number of such rights outstanding, are subject to adjustment from time to time to prevent dilution. Except as provided in the rights agreement, no adjustment in the purchase price or the number of shares of Series A Junior Participating Preferred Stock issuable upon exercise of a stockholder right will be required until the cumulative adjustment would require an increase or decrease of at least one percent in the purchase price or number of shares for which a right is exercisable.

At any time until the earlier of (1) the stock acquisition time or (2) the final expiration date of the rights agreement, we may redeem all the stockholder rights at a price of \$0.001 per right. At any time after a person has become an acquiring person and prior to the acquisition by such person of 50% or more of the outstanding shares of our common stock, we may exchange the stockholder rights, in whole or in part, at an exchange ratio of one share of common stock, or one one-thousandth of a share of Series A Junior Participating Preferred Stock or of a share of a class or series of preferred stock having equivalent rights, preferences and privileges, per right.

The stockholder rights plan is designed to protect stockholders in the event of unsolicited offers to acquire Principal Financial Group, Inc. and other coercive takeover tactics which, in the opinion of the company's board of directors, could impair its ability to represent stockholder interests. The provisions of the stockholder rights plan may render an unsolicited takeover more difficult or less likely to occur or may prevent such a takeover, even though such takeover may offer our stockholders the opportunity to sell their stock at a price above the prevailing market rate and may be favored by a majority of our stockholders.

#### TRANSFER AGENT AND REGISTRAR

The transfer agent and registrar for our common stock and our Series A Junior Participating Preferred Stock is Mellon Investor Services LLC.

#### COMMON STOCK ELIGIBLE FOR FUTURE SALE

Substantially all of the estimated 260.6 million shares of our common stock distributed to policyholders entitled to receive compensation in the demutualization or to the separate account to be established for the Separate Account Policy Credits will be eligible for resale in the public market without restriction. However, eligible policyholders will receive a written confirmation of their share ownership or Separate Account Policy Credits within 75 days from the closing of this offering, unless the Insurance Commissioner of the State of Iowa approves a later date. Until they receive the written confirmation, they will effectively be precluded from selling shares or the shares underlying their Separate Account Policy Credits because they will not know how many shares or Separate Account Policy Credits they will receive.

We estimate that these 260.6 million shares will equal approximately 72% of our outstanding common stock after the offering. See "The Demutualization." We have been advised by counsel that the distribution of shares to policyholders in the demutualization or to the separate account to be established for the Separate Account Policy Credits will be exempt from registration under the Securities Act by virtue of the exemption provided by Section 3(a)(10) of the Securities Act, and policyholders entitled to receive compensation in the demutualization who are not our "affiliates" within the meaning of Rule 144 under the Securities Act will be able to resell their shares, or to direct the sale of shares underlying Separate Account Policy Credits, immediately in the public market without registration or compliance with the time, volume, manner of sale and other limitations in Rule 144.

No prediction can be made as to the effect, if any, such future sales of shares, or the availability of shares for such future sales, will have on the market price of our common stock prevailing from time to time. The sale of substantial amounts of our common stock in the public market, or the perception that such sales could occur, could harm prevailing market prices for our common stock. See "Risk Factors -- Sales of shares distributed in the demutualization may reduce the market price of our common stock".

UNDERWRITING

Principal Financial Group, Inc. and the underwriters for the U.S. offering named below, referred to as the U.S. underwriters, have entered into an underwriting agreement with respect to the shares offered in the United States. Subject to certain conditions, each U.S. underwriter has severally agreed to purchase the number of shares indicated in the following table. Goldman, Sachs & Co., Credit Suisse First Boston Corporation, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Salomon Smith Barney Inc., Banc of America Securities LLC, Bear, Stearns & Co. Inc., A.G. Edwards & Sons, Inc., Fox-Pitt, Kelton Inc., J.P. Morgan Securities Inc., Lehman Brothers Inc., Samuel A. Ramirez & Company, Inc., and UBS Warburg LLC are the representatives of the U.S. underwriters.

Underwriters -----	Number of Shares -----
Goldman, Sachs & Co. ....	18,812,500
Credit Suisse First Boston Corporation.....	9,030,000
Merrill Lynch, Pierce, Fenner & Smith Incorporated.....	8,653,750
Salomon Smith Barney Inc. ....	8,653,750
Banc of America Securities LLC.....	3,762,500
Bear, Stearns & Co. Inc. ....	3,762,500
A.G. Edwards & Sons, Inc. ....	3,762,500
Fox-Pitt, Kelton Inc.....	3,762,500
J.P. Morgan Securities Inc. ....	3,762,500
Lehman Brothers Inc. ....	3,762,500
Samuel A. Ramirez & Company, Inc. ....	3,762,500
UBS Warburg LLC.....	3,762,500
ABN AMRO Rothschild LLC.....	500,000
Sanford C. Bernstein & Co., Inc. ....	500,000
Dain Rauscher Incorporated.....	500,000
Epoch Securities, Inc. ....	500,000
First Union Securities, Inc. ....	500,000
Keefe, Bruyette & Woods, Inc. ....	500,000
Prudential Securities Incorporated.....	500,000
Putnam Lovell Securities Inc. ....	500,000
RBC Dominion Securities Corporation.....	500,000
Robertson Stephens, Inc. ....	500,000
Sandler O'Neill & Partners, L.P. ....	500,000
Utendahl Capital Partners, L.P. ....	500,000
Wells Fargo Van Kasper, LLC.....	500,000
The Williams Capital Group, L.P. ....	500,000
BNY Capital Markets, Inc. ....	250,000
M.R. Beal & Company.....	250,000
Chatsworth Securities LLC.....	250,000
Doley Securities, Inc. ....	250,000
Guzman & Company.....	250,000
Legg Mason Wood Walker, Incorporated.....	250,000
Mitchell Securities Corporation of Oregon.....	250,000
Neuberger Berman, LLC.....	250,000
Raymond James & Associates, Inc. ....	250,000
Muriel Siebert & Co., Inc. ....	250,000
Sturdivant & Co., Inc. ....	250,000
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Total.....	85,000,000
	=====

If the U.S. underwriters sell more shares than the total number listed in the table above, the U.S. underwriters have an option to buy up to an additional 12,750,000 shares from Principal Financial Group, Inc. to cover such sales. They may exercise that option for 30 days. If any shares are purchased under this option, the U.S. underwriters will severally purchase shares in approximately the same proportion as shown in the table above.

The following table shows the per share and total underwriting discounts and commissions to be paid to the U.S. underwriters by Principal Financial Group, Inc. Such amounts are shown assuming both no exercise and full exercise of the U.S. underwriters' option to purchase 12,750,000 additional shares.

Paid by Principal Financial Group, Inc.

	No Exercise	Full Exercise
	-----	-----
Per Share.....	\$ 0.805	\$ 0.805
Total.....	\$68,403,750	\$78,664,313

Shares sold by the U.S. underwriters to the public will initially be offered at the initial public offering price provided on the cover of this prospectus. Any shares sold by the U.S. underwriters to securities dealers may be sold at a discount of up to \$0.49 per share from the initial public offering price. Any such securities dealers may resell any shares purchased from the U.S. underwriters to certain other brokers or dealers at a discount of up to \$0.10 per share from the initial public offering price. If all the shares are not sold at the initial offering price, the representatives may change the offering price and the other selling terms.

Principal Financial Group, Inc. has entered into an underwriting agreement with underwriters for the sale of 15,000,000 shares outside of the United States. The terms and conditions of both offerings are the same and the sale of shares in both offerings are conditioned on each other. Goldman Sachs International, Credit Suisse First Boston (Europe) Limited, Merrill Lynch International, Salomon Brothers International Limited, Banc of America Securities Limited, Bear, Stearns International Limited, A.G. Edwards & Sons, Inc., Fox-Pitt, Kelton N.V., J.P. Morgan Securities Ltd., Lehman Brothers International (Europe), Samuel A. Ramirez & Company, Inc., UBS AG, acting through its business group UBS Warburg, ABN AMRO Rothschild, BNP Paribas, Commerzbank Aktiengesellschaft and Credit Lyonnais are referred to as the international underwriters. Principal Financial Group, Inc. has granted the international underwriters a similar option to purchase up to an aggregate of an additional 2,250,000 shares.

The underwriters for both of the offerings will enter into an agreement in which they will agree to restrictions on where and to whom they and any dealer purchasing from them may offer shares as a part of the distribution of the shares. The underwriters will also agree that they may sell shares among each of the underwriting groups.

Principal Financial Group, Inc. has agreed with the underwriters not to dispose of or hedge any shares of common stock or securities convertible into or exchangeable for shares of common stock during the period from the date of this prospectus continuing through the date 180 days after the date of this prospectus, except with the prior written consent of the representatives. This restriction does not apply to: (1) shares of our common stock issued to a new separate account of Principal Life, held for the benefit of Qualified Plan Customers, as part of the Separate Account Policy Credits and (2) employee stock option plans existing on, or upon the conversion or exchange of convertible or exchangeable securities outstanding as of, the date of the underwriting agreement. See "Common Stock Eligible for Future Sale" for a discussion of transfer restrictions.

Prior to the offering, there has been no public market for the shares. The initial public offering price has been negotiated among us and the representatives. Among the factors to be considered in determining the initial public offering price of the shares, in addition to prevailing market conditions, will be the historical performance of Principal Financial Group, Inc., estimates of its business potential and earnings prospects, an assessment of its management and the consideration of the above factors in relation to market valuation of companies in related businesses.

The common stock of Principal Financial Group, Inc. has been approved for listing on the New York Stock Exchange under the symbol "PFG", subject to official notice of issuance.

In connection with the offering, the underwriters may purchase and sell shares of common stock in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering. "Covered" short sales are sales made in an amount not greater than the underwriters' option to purchase additional shares from us in the offering. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option. "Naked" short sales are any sales in excess of such option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the common stock in the open market after pricing that could adversely affect investors who purchase in the offering. Stabilizing transactions consist of various bids for or purchases of common stock made by the underwriters in the open market prior to the completion of the offering.





The underwriters may also impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the representatives have repurchased shares sold by or for the account of such underwriter in stabilizing or short covering transactions.

Purchases to cover a short position and stabilizing transactions may have the effect of preventing or retarding a decline in the market price of the common stock, and together with the imposition of the penalty bid may stabilize, maintain or otherwise affect the market price of the common stock. As a result, the price of the common stock may be higher than the price that otherwise might exist in the open market. If these activities are commenced, they may be discontinued at any time. These transactions may be effected on the New York Stock Exchange, in the over-the-counter market or otherwise.

The underwriters do not expect sales to discretionary accounts to exceed five percent of the total number of shares offered.

A prospectus in electronic format will be made available on the web sites maintained by the lead manager of this offering and may also be made available on web sites maintained by other underwriters. The underwriters may agree to allocate a number of shares to underwriters for sale to their online brokerage account holders. Internet distributions will be allocated by the lead manager to underwriters that may make Internet distributions on the same basis as other allocations.

Principal Financial Group, Inc. estimates that its share of the total expenses of this offering, excluding underwriting discounts and commissions, will be approximately \$16.2 million.

Principal Financial Group, Inc. and Principal Life Insurance Company have agreed to, jointly and severally, indemnify the several underwriters against liabilities, including liabilities under the Securities Act of 1933.

Certain of the underwriters and their affiliates have in the past provided, and may in the future from time to time provide, investment banking and general financing and banking services to Principal Financial Group, Inc. and its affiliates for which they have in the past received, and may in the future receive, customary fees.

## VALIDITY OF COMMON STOCK

The validity of the shares of our common stock offered hereby will be passed upon for Principal Financial Group, Inc. by Debevoise & Plimpton, New York, New York and for the underwriters by LeBoeuf, Lamb, Greene & MacRae, L.L.P., a limited liability partnership including professional corporations, New York, New York. LeBoeuf, Lamb, Greene & MacRae, L.L.P. has in the past performed, and continues to perform, legal services for us and our affiliates.

## EXPERTS

Ernst & Young LLP, independent auditors, have audited our consolidated financial statements at December 31, 2000 and 1999, and for each of the three years in the period ended December 31, 2000, as described in their report. We have included our consolidated financial statements in this prospectus and in the registration statement in reliance on Ernst & Young LLP's report, given on their authority as experts in accounting and auditing.

Daniel J. McCarthy, F.S.A., a consulting actuary associated with Milliman, has rendered an opinion, dated March 31, 2001, to our board of directors. See "The Demutualization -- Actuarial Opinion." This opinion is included as Annex A of this prospectus. This opinion is included in reliance upon the authority of such actuary as an expert in actuarial matters generally and in the application of actuarial concepts to insurance matters.

## ADDITIONAL INFORMATION

We have filed with the Securities and Exchange Commission in Washington, D.C., a registration statement on Form S-1 under the Securities Act with respect to the common stock offered by this prospectus. This prospectus which forms a part of the registration statement does not contain all the information found in the registration statement, certain parts of which are omitted in accordance with the rules and regulations of the Securities and Exchange Commission. For further information with respect to Principal Financial Group, Inc. and our common stock, we refer you to the registration statement. Statements made in this prospectus describing the contents of any contract, agreement or other document referred to are not necessarily complete. With respect to each such contract, agreement or other document filed as an exhibit to the registration statement, reference is made to the exhibit for a more complete description of the matter involved, and each such statement is qualified in its entirety by such reference. The registration statement may be inspected and copied at the Securities and Exchange Commission's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Securities and Exchange Commission maintains an Internet site, <http://www.sec.gov> that contains periodic and current reports, proxy and information statements, and other information regarding issuers that file electronically with the Securities and Exchange Commission.

As a result of the offering we will become subject to the information reporting requirements of the Securities Exchange Act of 1934. We will fulfill our obligations with respect to such requirements by filing periodic and current reports, proxy statements and other information with the Securities and Exchange Commission. Such reports, proxy statements and information may be inspected and copied at the public reference facilities maintained by the Securities and Exchange Commission referenced above. We intend to furnish holders of our common stock with annual reports that include our annual consolidated financial statements audited by an independent certified public accounting firm and quarterly reports for the first three quarters of each fiscal year containing unaudited interim financial information.

Our common stock has been approved for listing on the New York Stock Exchange under the symbol "PFG", subject to official notice of issuance. Upon such listing, copies of the registration statement, including all exhibits to the registration statement, and periodic reports, proxy statements and other information will be available for inspection at the offices of the New York Stock Exchange, Inc. located at 20 Broad Street, New York, New York 10005.

## GLOSSARY

The following Glossary includes definitions of terms which are unique to this offering. Each term defined in this Glossary is printed in boldface the first time it appears in this prospectus.

### Account Value Policy

**Credits**.....Policy credits, in the form of an increase in the value of the applicable group annuity contract, issued to a Qualified Plan Customer or a Non-Rule 180 Qualified Plan Customer. The increase in value will be allocated to participants' accounts, where appropriate, based on account balances for which records are kept by Principal Life Insurance Company unless the Qualified Plan Customer or Non-Rule 180 Qualified Plan Customer directs otherwise.

**Closed Block**.....A mechanism established by Principal Life Insurance Company for the benefit of the participating policies and contracts included in the Closed Block, in connection with its reorganization to the mutual insurance holding company structure effective July 1, 1998. Assets of Principal Life Insurance Company were allocated to the Closed Block in an amount that produces cash flows which, together with anticipated revenue from the Closed Block policies and contracts, are expected to be sufficient to support the Closed Block policies and contracts including, but not limited to, provisions for payment of claims and certain expenses and taxes, and to provide for continuation of policy and contract dividends in aggregate in accordance with the 1997 dividend scales if the experience underlying those scales continues, and to allow for appropriate adjustments in those scales if such experience changes.

### Interest Maintenance

**Reserve**.....The reserve required by insurance regulators to capture non-credit, interest-related realized capital gains and losses (net of taxes) on fixed income investments (primarily bonds and mortgage loans), which are amortized into net income over the estimated otherwise remaining periods to maturity of the investments sold. The Interest Maintenance Reserve has no effect on financial statements prepared in conformity with GAAP.

**Mandatory Policy Credits**...Policy credits issued to holders of policies required to receive policy credits under the plan of conversion. Mandatory Policy Credits may take the form of an increase in cash value, account value, dividend accumulations, face amount, extended term period or benefit payment, as appropriate, depending on the policy.

**NAIC Designations**.....Evaluation made by the Securities Valuation Office of the National Association of Insurance Commissioners of the bond investments of insurers for regulatory reporting purposes and assignments of securities to one of six investment categories.

### Non-Rule 180 Qualified Plan

**Customers**.....Owners of group annuity contracts issued by Principal Life Insurance Company designed to fund benefits under a retirement plan which is qualified under Section 401(a) or Section 403(a) of the Internal Revenue Code and which covers employees described in Section 401(c) of the Internal Revenue Code but which does not meet the requirements of Rule 180 promulgated under the Securities Act of 1933.

**Qualified Plan Customers**...Owners of group annuity contracts issued by Principal Life Insurance Company designed to fund benefits under a retirement plan which is qualified under Section 401(a) or Section 403(a) of the Internal Revenue Code (including a plan covering employees described in Section 401(c) of the Internal Revenue Code, provided such plan meets the requirements of Rule 180 promulgated under the Securities Act of 1933) or which is a governmental plan described in Section 414(d) of the Internal Revenue Code, excluding (i) group annuity contracts that fund only guaranteed deferred annuities or annuities in the course of payments and (ii) group annuity contracts for which Principal Life Insurance Company does not perform retirement plan record keeping services and whose group annuity contracts do not provide for investments in Principal Life Insurance Company's pooled unregistered separate accounts.

**Restricted Stock**.....Awards of common stock subject to restrictions on transferability and a risk of forfeiture.

Restricted Stock Units.....Contractual rights to receive cash or common stock in the future that are the economic equivalent of an award of Restricted Stock.

Separate Account Policy Credits.....Policy credits issued to a Qualified Plan Customer in the form of an addition to the Qualified Plan Customer's group annuity contract of an interest in a separate account holding shares of our common stock and maintained by Principal Life Insurance Company. The separate account interests issued as Separate Account Policy Credits to a Qualified Plan Customer will be allocated to plan participants' accounts, where appropriate, based on account balances for which records are kept by Principal Life Insurance Company unless the Qualified Plan Customer directs otherwise.

Stock Appreciation Rights.....Rights to receive cash or stock based on the appreciation in value of the common stock from the date of grant.

PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED FINANCIAL STATEMENTS  
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UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS -- FOR THE SIX  
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REPORT OF INDEPENDENT AUDITORS

The Board of Directors  
Principal Mutual Holding Company

We have audited the accompanying consolidated statements of financial position of Principal Mutual Holding Company (the Company) as of December 31, 2000 and 1999, and the related consolidated statements of operations, equity and cash flows for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Principal Mutual Holding Company at December 31, 2000 and 1999, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

/s/

Ernst & Young LLP  
Des Moines, Iowa  
February 2, 2001, except for Note 16,  
as to which the date is September 11, 2001

PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF OPERATIONS

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
	(IN MILLIONS)		
<b>REVENUES</b>			
Premiums and other considerations.....	\$3,996.4	\$3,937.6	\$3,818.4
Fees and other revenue.....	1,576.3	1,287.3	978.8
Net investment income.....	3,172.3	3,072.0	2,933.9
Net realized capital gains.....	139.9	404.5	465.8
<b>Total revenues.....</b>	<b>8,884.9</b>	<b>8,701.4</b>	<b>8,196.9</b>
<b>EXPENSES</b>			
Benefits, claims and settlement expenses.....	5,232.3	5,260.9	5,089.0
Dividends to policyholders.....	312.7	304.6	298.7
Operating expenses.....	2,479.4	2,070.3	2,074.0
<b>Total expenses.....</b>	<b>8,024.4</b>	<b>7,635.8</b>	<b>7,461.7</b>
Income before income taxes.....	860.5	1,065.6	735.2
Income taxes.....	240.3	323.5	42.2
<b>Net income.....</b>	<b>\$ 620.2</b>	<b>\$ 742.1</b>	<b>\$ 693.0</b>
	=====	=====	=====

See accompanying notes.  
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PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

	DECEMBER 31,	
	2000	1999
	(IN MILLIONS)	
<b>ASSETS</b>		
Fixed maturities, available-for-sale.....	\$26,839.9	\$23,443.9
Equity securities, available-for-sale.....	742.9	864.2
Mortgage loans.....	11,492.7	13,332.2
Real estate.....	1,400.5	2,212.0
Policy loans.....	803.6	780.5
Other investments.....	811.0	710.4
	-----	-----
Total investments.....	42,090.6	41,343.2
Cash and cash equivalents.....	926.6	569.5
Accrued investment income.....	530.8	472.0
Premiums due and other receivables.....	505.7	540.5
Deferred policy acquisition costs.....	1,333.3	1,430.9
Property and equipment.....	507.0	507.7
Goodwill and other intangibles.....	1,375.9	1,471.5
Mortgage loan servicing rights.....	1,084.4	1,081.0
Separate account assets.....	34,916.2	34,992.3
Other assets.....	1,134.4	1,544.6
	-----	-----
Total assets.....	\$84,404.9	\$83,953.2
	=====	=====
<b>LIABILITIES</b>		
Contractholder funds.....	\$24,300.2	\$24,519.8
Future policy benefits and claims.....	13,346.0	12,612.2
Other policyholder funds.....	597.4	676.9
Short-term debt.....	459.5	547.3
Long-term debt.....	1,336.5	1,492.9
Income taxes currently payable.....	108.4	153.2
Deferred income taxes.....	487.4	271.7
Separate account liabilities.....	34,916.2	34,992.3
Other liabilities.....	2,600.8	3,134.0
	-----	-----
Total liabilities.....	78,152.4	78,400.3
<b>EQUITY</b>		
Retained earnings.....	6,312.5	5,692.3
Accumulated other comprehensive income (loss):		
Net unrealized gains (losses) on available-for-sale securities.....	129.9	(79.1)
Net foreign currency translation adjustment.....	(189.9)	(60.3)
	-----	-----
Total equity.....	6,252.5	5,552.9
	-----	-----
Total liabilities and equity.....	\$84,404.9	\$83,953.2
	=====	=====

See accompanying notes.  
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PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF EQUITY

	RETAINED EARNINGS	NET UNREALIZED GAINS (LOSSES) ON AVAILABLE-FOR-SALE SECURITIES	NET FOREIGN CURRENCY TRANSLATION ADJUSTMENT	TOTAL EQUITY
	(IN MILLIONS)			
BALANCES AT JANUARY 1, 1998.....	\$4,257.2	\$ 1,037.5	\$ (10.5)	\$ 5,284.2
Comprehensive income:				
Net income.....	693.0	--	--	693.0
Net change in unrealized gains and losses on fixed maturities, available-for-sale.....	--	(203.3)	--	(203.3)
Net change in unrealized gains and losses on equity securities, available-for-sale, including seed money in separate accounts.....	--	(291.3)	--	(291.3)
Adjustments for assumed changes in amortization patterns:				
Deferred policy acquisition costs.....	--	37.1	--	37.1
Unearned revenue reserves.....	--	(3.6)	--	(3.6)
Provision for deferred income tax benefit.....	--	169.5	--	169.5
Change in net foreign currency translation adjustment.....	--	--	(18.4)	(18.4)
Comprehensive income.....	-----	-----	-----	----- 383.0
BALANCES AT DECEMBER 31, 1998.....	4,950.2	745.9	(28.9)	5,667.2
Comprehensive loss:				
Net income.....	742.1	--	--	742.1
Net change in unrealized gains and losses on fixed maturities, available-for-sale.....	--	(1,375.4)	--	(1,375.4)
Net change in unrealized gains and losses on equity securities, available-for-sale, including seed money in separate accounts.....	--	(119.2)	--	(119.2)
Adjustments for assumed changes in amortization patterns:				
Deferred policy acquisition costs.....	--	246.1	--	246.1
Unearned revenue reserves.....	--	(29.5)	--	(29.5)
Provision for deferred income tax benefit.....	--	453.0	--	453.0
Change in net foreign currency translation adjustment.....	--	--	(31.4)	(31.4)
Comprehensive loss.....	-----	-----	-----	----- (114.3)
BALANCES AT DECEMBER 31, 1999.....	5,692.3	(79.1)	(60.3)	5,552.9
Comprehensive income:				
Net income.....	620.2	--	--	620.2
Net change in unrealized gains and losses on fixed maturities, available-for-sale.....	--	721.8	--	721.8
Net change in unrealized gains and losses on equity securities, available-for-sale, including seed money in separate accounts.....	--	(285.3)	--	(285.3)
Adjustments for assumed changes in amortization patterns:				
Deferred policy acquisition costs.....	--	(122.6)	--	(122.6)
Unearned revenue reserves.....	--	15.1	--	15.1
Provision for deferred income taxes.....	--	(120.0)	--	(120.0)
Change in net foreign currency translation adjustment.....	--	--	(129.6)	(129.6)
Comprehensive income.....	-----	-----	-----	----- 699.6
BALANCES AT DECEMBER 31, 2000.....	<u>\$6,312.5</u>	<u>\$ 129.9</u>	<u>\$(189.9)</u>	<u>\$ 6,252.5</u>

See accompanying notes.  
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PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
	(IN MILLIONS)		
<b>OPERATING ACTIVITIES</b>			
Net income.....	\$ 620.2	\$ 742.1	\$ 693.0
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of deferred policy acquisition costs.....	238.6	173.8	218.9
Additions to deferred policy acquisition costs.....	(263.9)	(253.9)	(229.0)
Accrued investment income.....	(58.8)	(41.2)	22.9
Premiums due and other receivables.....	(38.3)	34.4	(23.8)
Contractholder and policyholder liabilities and dividends.....	1,478.5	1,650.6	1,638.0
Current and deferred income taxes.....	75.0	155.6	(266.2)
Net realized capital gains.....	(139.9)	(404.5)	(465.8)
Depreciation and amortization expense.....	153.6	117.1	137.8
Amortization and impairment/recovery of mortgage servicing rights.....	157.3	94.4	142.3
Other.....	415.0	(162.4)	95.0
Net adjustments.....	2,017.1	1,363.9	1,270.1
Net cash provided by operating activities.....	2,637.3	2,106.0	1,963.1
<b>INVESTING ACTIVITIES</b>			
Available-for-sale securities:			
Purchases.....	(13,051.0)	(11,510.2)	(7,475.1)
Sales.....	7,366.0	7,031.0	5,857.2
Maturities.....	2,675.3	2,599.2	1,376.7
Mortgage loans acquired or originated.....	(10,507.5)	(16,594.6)	(14,261.4)
Mortgage loans sold or repaid.....	12,026.8	16,361.5	14,477.8
Net change in mortgage servicing rights.....	(182.9)	(307.5)	(387.4)
Real estate acquired.....	(324.4)	(449.7)	(436.3)
Real estate sold.....	796.9	869.8	661.6
Net change in property and equipment.....	(67.1)	(61.2)	(69.6)
Proceeds from sales of subsidiaries.....	--	41.7	95.5
Purchases of interest in subsidiaries, net of cash acquired.....	(27.4)	(1,154.6)	(217.7)
Net change in other investments.....	22.0	(166.6)	(360.9)
Net cash used in investing activities.....	(1,273.3)	(3,341.2)	(739.6)
<b>FINANCING ACTIVITIES</b>			
Issuance of debt.....	230.4	885.2	243.0
Principal repayments of debt.....	(120.7)	(40.2)	(50.9)
Proceeds of short-term borrowings.....	2,417.5	5,150.9	8,627.7
Repayment of short-term borrowings.....	(2,505.4)	(4,895.7)	(8,924.3)
Investment contract deposits.....	3,982.6	5,325.4	5,854.1
Investment contract withdrawals.....	(5,011.3)	(5,081.7)	(7,058.3)
Net cash provided by (used in) financing activities.....	(1,006.9)	1,343.9	(1,308.7)
Net increase (decrease) in cash and cash equivalents.....	357.1	108.7	(85.2)
Cash and cash equivalents at beginning of year.....	569.5	460.8	546.0
Cash and cash equivalents at end of year.....	\$ 926.6	\$ 569.5	\$ 460.8
=====			
<b>SCHEDULE OF NONCASH OPERATING AND INVESTING ACTIVITIES</b>			
Net transfer of noncash assets and liabilities to an unconsolidated limited liability company in exchange for a minority interest.....	\$ (255.0)		
=====			
Net transfer of noncash assets and liabilities of Principal Health Care Inc. on April 1, 1998 in exchange for common shares of Coventry Health Care, Inc.....			\$ (160.0)
=====			

See accompanying notes.  
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PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2000

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

REORGANIZATION

Effective July 1, 1998, Principal Mutual Life Insurance Company formed a mutual insurance holding company ("Principal Mutual Holding Company") and converted to a stock life insurance company ("Principal Life Insurance Company"). All of the shares of Principal Life Insurance Company ("Principal Life") were issued to Principal Mutual Holding Company through two newly formed intermediate holding companies, Principal Financial Group, Inc. and Principal Financial Services, Inc. The reorganization itself did not have a material financial impact on Principal Mutual Holding Company and its consolidated subsidiaries, as the net assets so transferred to achieve the change in legal organization were accounted for at historical carrying amounts in a manner similar to that in pooling-of-interests accounting.

PLAN OF DEMUTUALIZATION

In 2000, the Board of Directors approved management's recommendation to develop a plan of demutualization to convert Principal Mutual Holding Company into a stock company. Management expects to complete development of the plan of demutualization in the first half of 2001. The plan will primarily address how the organization will be restructured, required approvals, and eligibility for and allocation of policyholder compensation. The proposed plan, when completed, will be subject to approval by the Board of Directors, eligible policyholders of Principal Life Insurance Company and the Insurance Commissioner of the State of Iowa. See Note 16.

DESCRIPTION OF BUSINESS

Principal Mutual Holding Company and its consolidated subsidiaries ("the Company") is a diversified financial services organization engaged in the marketing and management of retirement savings, investment and insurance products and services in the United States and selected international markets and residential mortgage loan origination and servicing in the United States.

BASIS OF PRESENTATION

The accompanying consolidated financial statements of the Company and its majority-owned subsidiaries have been prepared in conformity with accounting principles generally accepted in the United States ("GAAP"). Less than majority-owned entities in which the Company has at least a 20% interest are reported on the equity basis in the consolidated statements of financial position as other investments. All significant intercompany accounts and transactions have been eliminated.

Total assets of the unconsolidated entities amounted to \$3,098.5 million at December 31, 2000 and \$3,276.6 million at December 31, 1999. Total revenues of the unconsolidated entities were \$2,226.3 million in 2000, \$1,978.9 million in 1999 and \$1,749.9 million in 1998. During 2000, 1999 and 1998, the Company included \$39.1 million, \$107.7 million and \$18.2 million, respectively, in net investment income representing the Company's share of current year net income of the unconsolidated entities.

CLOSED BLOCK

In conjunction with the formation of the mutual insurance holding company, Principal Life established a closed block for the benefit of individual participating dividend-paying policies in force on that date. The closed block was designed to provide reasonable assurance to policyholders included therein that, after the Reorganization, assets would be available to maintain dividends in aggregate in accordance with the 1997 policy dividend scales if the experience underlying such scales continued. Assets were allocated to the closed block in amounts such that their cash flows together with anticipated revenues from policies included in the closed block, were reasonably expected to be sufficient to support such policies, including provision for payment of claims, expenses, charges and taxes, and to provide for the continuation of dividends in aggregate in accordance with the 1997 policy dividend scales if the experience underlying such scales continued, and to allow for appropriate adjustments in such scales if the experience changes.

Assets allocated to the closed block inure to the benefits of the holders of policies included in the closed block. Closed block assets and liabilities are carried on the same basis as similar assets and liabilities held by the Company. Principal Life will continue to pay guaranteed benefits under all policies, including the policies included in the closed block, in accordance with their terms. If the assets allocated to the closed block, the investment cash flows from those assets and the revenues from the policies included in the closed block, including investment income thereon, prove to

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

be insufficient to pay the benefits guaranteed under the policies included in the closed block, Principal Life will be required to make such payments from its general funds. See Note 6.

## USE OF ESTIMATES IN THE PREPARATION OF FINANCIAL STATEMENTS

The preparation of the Company's consolidated financial statements and accompanying notes requires management to make estimates and assumptions that affect the amounts reported and disclosed. These estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed in the consolidated financial statements and accompanying notes.

## CASH AND CASH EQUIVALENTS

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

## INVESTMENTS

Investments in fixed maturities and equity securities are classified as available-for-sale and, accordingly, are carried at fair value. (See Note 13 for policies related to the determination of fair value.) The cost of fixed maturities is adjusted for amortization of premiums and accrual of discounts, both computed using the interest method. The cost of fixed maturities and equity securities is adjusted for declines in value that are other than temporary. For the loan-backed and structured securities included in the bond portfolio, the Company recognizes income using a constant effective yield based on currently anticipated prepayments as determined by broker-dealer surveys or internal estimates and the estimated lives of the securities.

Real estate investments are reported at cost less accumulated depreciation. The initial cost bases of properties acquired through loan foreclosures are fair market values of the properties at the time of foreclosure. Buildings and land improvements are generally depreciated on the straight-line method over the estimated useful life of improvements, and tenant improvement costs are depreciated on the straight-line method over the term of the related lease. The Company recognizes impairment losses for its properties when indicators of impairment are present and a property's expected undiscounted cash flows are not sufficient to recover the property's carrying value. In such cases, the cost bases of the properties are reduced to fair value. Real estate expected to be disposed is carried at the lower of cost or fair value, less cost to sell, with valuation allowances established accordingly and depreciation no longer recognized. Any impairment losses and any changes in valuation allowances are reported as net realized capital losses.

Commercial and residential mortgage loans are generally reported at cost adjusted for amortization of premiums and accrual of discounts, computed using the interest method, and net of valuation allowances. Any changes in the valuation allowances are reported as net realized capital gains (losses). The Company measures impairment based upon the present value of expected cash flows discounted at the loan's effective interest rate. If foreclosure is probable, the measurement of any valuation allowance is based upon the fair value of the collateral. The Company has residential mortgage loans held for sale in the amount of \$251.7 million and \$432.1 million and commercial mortgage loans held for sale in the amount of \$520.9 million and \$280.1 million at December 31, 2000 and 1999, respectively, which are carried at lower of cost or fair value and reported as mortgage loans in the statements of financial position.

Net realized capital gains and losses on investments are determined using the specific identification basis.

Policy loans and other investments, excluding investments in unconsolidated entities, are primarily reported at cost.

## SECURITIZATIONS

The Company sells commercial mortgage loans to an unconsolidated trust which then issues mortgage-backed securities. The Company may retain interests in the loans by purchasing portions of the securities from the issuance. Gain or loss on the sales of the mortgages depends in part on the previous carrying amounts of the financial assets involved in the transfer, which is allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer. Fair values are determined by quoted market prices of external buyers of each class of security purchased. The retained interests are thereafter carried at fair value as is the case of other fixed maturity investments.

The Company also sells residential mortgage loans in securitization transactions, and retains servicing rights which are retained interests in the securitized loans. Gain or loss on the sales of the loans depends in part on the previous carrying amounts of the financial assets sold and the retained interests based on their relative fair values at the date of

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

the transfer. To obtain fair values, quoted market prices are used if available. However, quotes are generally not available for retained interests, so the Company estimates fair value based on the present value of the future expected cash flows using management's best estimates of the key assumptions -- prepayment speeds and option adjusted spreads commensurate with the risks involved.

The Company has developed a margin lending securitization program whereby the Company sells receivables to an unconsolidated trust that packages and sells interests to investors. The Company retains interest bearing subordinated tranches. The receivables are sold at face value, which approximates cost and fair value, to an unconsolidated trust, with no gain or loss recognized on the sale. Retained interests are initially carried at cost based on their relative fair values at the date of transfer, then carried at fair value thereafter.

## DERIVATIVES

Derivatives are generally held for purposes other than trading and are primarily used to hedge or reduce exposure to interest rate and foreign currency risks associated with assets held or expected to be purchased or sold, and liabilities incurred or expected to be incurred. Additionally, derivatives are used to change the characteristics of the Company's asset/liability mix consistent with the Company's risk management activities.

The Company's risk of loss is typically limited to the fair value of its derivative instruments and not to the notional or contractual amounts of these derivatives. Risk arises from changes in the fair value of the underlying instruments. The Company is also exposed to credit losses in the event of nonperformance of the counterparties. This credit risk is minimized by purchasing such agreements from financial institutions with high credit ratings and by establishing and monitoring exposure limits.

The Company's use of derivatives is further described in Note 5. The net interest effect of interest rate and currency swap transactions is recorded as an adjustment to net investment income or interest expense, as appropriate, over the periods covered by the agreements. The cost of other derivative contracts is amortized over the life of the contracts and classified with the results of the underlying hedged item. Certain contracts are designated as hedges of specific assets and, to the extent those assets are marked to market, the hedge contracts are also marked to market and included as an adjustment of the underlying asset value. Other contracts are designated and accounted for as hedges of certain liabilities and are not marked to market. Futures contracts and mortgage-backed forwards are used to hedge anticipated transactions. Futures contracts are marked to market value and settled daily. However, changes in the market value of such contracts have not qualified for inclusion in the measurements of subsequent transactions or represent hedges of items reported at fair value. Accordingly, such changes in market value are reported in net income in the period of change.

Hedge accounting is used for derivatives that are specifically designated in advance as hedges and that reduce the Company's exposure to an indicated risk by having a high correlation between changes in the value of the derivatives and the items being hedged at both the inception of the hedge and throughout the hedge period. Should such criteria not be met or if the hedged items are sold, terminated or matured, the changes in value of the derivatives are included in net income.

## CONTRACTHOLDER AND POLICYHOLDER LIABILITIES

Contractholder and policyholder liabilities (contractholder funds, future policy benefits and claims, and other policyholder funds) include reserves for investment contracts and reserves for universal life, limited payment, participating and traditional life insurance policies. Investment contracts are contractholders' funds on deposit with the Company and generally include reserves for pension and annuity contracts. Reserves on investment contracts are equal to the cumulative deposits less any applicable charges plus credited interest.

Reserves for universal life insurance contracts are equal to cumulative premiums less charges plus credited interest which represents the account balances that accrue to the benefit of the policyholders. Reserves for non-participating term life insurance contracts are computed on a basis of assumed investment yield, mortality, morbidity and expenses, including a provision for adverse deviation, which generally vary by plan, year of issue and policy duration. Investment yield is based on the Company's experience. Mortality, morbidity and withdrawal rate assumptions are based on experience of the Company and are periodically reviewed against both industry standards and experience.

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

Participating business represented approximately 34%, 34% and 36% of the Company's life insurance in force and 79%, 78% and 81% of the number of life insurance policies in force at December 31, 2000, 1999 and 1998, respectively. Participating business represented approximately 61%, 63% and 76% of life insurance premiums for the years ended December 31, 2000, 1999 and 1998, respectively.

The amount of dividends to policyholders is approved annually by Principal Life's Board of Directors. The amount of dividends to be paid to policyholders is determined after consideration of several factors including interest, mortality, morbidity and other expense experience for the year and judgment as to the appropriate level of statutory surplus to be retained by Principal Life. At the end of the reporting period, Principal Life establishes a dividend liability for the pro-rata portion of the dividends expected to be paid on or before the next policy dividend anniversary date.

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

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

## RECOGNITION OF PREMIUMS AND OTHER CONSIDERATIONS, FEES AND OTHER REVENUES AND BENEFITS

Traditional individual life and health insurance products include those products with fixed and guaranteed premiums and benefits, and consist principally of whole life and term life insurance policies and certain immediate annuities with life contingencies. Premiums from these products are recognized as premium revenue when due.

Immediate annuities with life contingencies include products with fixed and guaranteed annuity considerations and benefits, and consist primarily of group and individual single premium annuities with life contingencies. Annuity considerations from these products are recognized as revenue when due.

Group life and health insurance premiums are generally recorded as premium revenue over the term of the coverage. Some group contracts allow for premiums to be adjusted to reflect emerging experience. Such adjusted premiums are recognized in the period that the related experience emerges. Fees for contracts providing claim processing or other administrative services are recorded over the period the service is provided.

Related policy benefits and expenses for individual and group life and health insurance products are associated with earned premiums and result in the recognition of profits over the expected lives of the policies and contracts.

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

Fees and other revenues arising from the residential mortgage banking operations consist of revenues earned for servicing and originating residential mortgage loans as well as marketing other products to servicing portfolio customers. Servicing revenues are recognized as the mortgage loan is serviced over the life of the mortgage loan. Mortgage loans originated are sold in the secondary mortgage markets, shortly after origination. As a result, mortgage loan origination fee revenues are recognized when the mortgage loans are sold. Fee revenues received for marketing other products to servicing portfolio customers are recognized when the service is performed. Net revenues are also recognized upon the sale of residential mortgage loans and residential mortgage loan servicing rights and are determined using the specific identification basis.

DEFERRED POLICY ACQUISITION COSTS

Commissions and other costs (underwriting, issuance and agency expenses) that vary with and are primarily related to the acquisition of new and renewal insurance policies and investment contract business are capitalized to the extent recoverable. Acquisition costs that are not deferrable and maintenance costs are charged to operations as incurred.

Deferred policy acquisition costs for universal life-type insurance contracts and participating life insurance policies and investment contracts are being amortized over the lives of the policies and contracts in relation to the emergence of estimated gross profit margins. This amortization is adjusted retrospectively when estimates of current or future gross profits and margins to be realized from a group of products and contracts are revised. The deferred policy acquisition costs of non-participating term life insurance policies are being amortized over the premium-paying period of the related policies using assumptions consistent with those used in computing policyholder liabilities.

Deferred policy acquisition costs are subject to recoverability testing at the time of policy issue and loss recognition testing at the end of each accounting period. Deferred policy acquisition costs would be written off to the extent that it is determined that future policy premiums and investment income or gross profit margins would not be adequate to cover related losses and expenses.

REINSURANCE

The Company enters into reinsurance agreements with other companies in the normal course of business. The Company may assume reinsurance from or cede reinsurance to other companies. Premiums and expenses are reported net of reinsurance ceded. The Company is contingently liable with respect to reinsurance ceded to other companies in the event the reinsurer is unable to meet the obligations it has assumed. At December 31, 2000, 1999 and 1998 respectively, the Company had reinsured \$13.2 billion, \$10.2 billion and \$6.9 billion of life insurance in force, representing 9%, 7% and 5% of total net life insurance in force through a single third-party reinsurer. To minimize the possibility of losses, the Company evaluates the financial condition of its reinsurers and continually monitors concentrations of credit risk.

The effect of reinsurance on premiums and other considerations and policy and contract benefits and changes in reserves is as follows (in millions):

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
Premiums and other considerations:			
Direct.....	\$4,142.1	\$3,990.0	\$3,799.9
Assumed.....	24.6	4.1	62.2
Ceded.....	(170.3)	(56.5)	(43.7)
Net premiums and other considerations.....	\$3,996.4	\$3,937.6	\$3,818.4
Benefits, claims and settlement expenses:			
Direct.....	\$5,387.8	\$5,296.1	\$5,051.5
Assumed.....	1.9	(1.3)	66.0
Ceded.....	(157.4)	(33.9)	(28.5)
Net benefits, claims and settlement expenses.....	\$5,232.3	\$5,260.9	\$5,089.0

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

GUARANTY-FUND ASSESSMENTS

Guaranty-fund assessments are accrued for anticipated assessments, which are estimated using data available from various industry sources that monitor the current status of open and closed insolvencies. The Company has also established an other asset for assessments expected to be recovered through future premium tax offsets.

SEPARATE ACCOUNTS

The separate account assets and liabilities presented in the consolidated financial statements represent the fair market value of funds that are separately administered by the Company for contracts with equity, real estate and fixed-income investments. Generally, the separate account contract owner, rather than the Company, bears the investment risk of these funds. The separate account assets are legally segregated and are not subject to claims that arise out of any other business of the Company. The Company receives a fee for administrative, maintenance and investment advisory services that is included in the consolidated statements of operations. Net deposits, net investment income and realized and unrealized capital gains and losses on the separate accounts are not reflected in the consolidated statements of operations.

INCOME TAXES

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

FOREIGN EXCHANGE

The Company's foreign subsidiaries' statements of financial position and operations are translated at the current exchange rates and average exchange rates for the year, respectively. Resulting translation adjustments for foreign subsidiaries and certain other transactions are reported as a component of equity. Other translation adjustments for foreign currency transactions that affect cash flows are reported in current operations.

PENSION AND POSTRETIREMENT BENEFITS

The Company accounts for its pension benefits and postretirement benefits other than pension (medical, life insurance and long-term care) using the full accrual method.

PROPERTY AND EQUIPMENT

Property and equipment includes home office properties, related leasehold improvements, purchased and internally developed software and other fixed assets. Property and equipment use is shown in the consolidated statements of financial position at cost less allowances for accumulated depreciation. Provisions for depreciation of property and equipment are computed principally on the straight-line method over the estimated useful lives of the assets. Property and equipment and related accumulated depreciation are as follows (in millions):

	DECEMBER 31,	
	2000	1999
	-----	-----
Property and equipment.....	\$ 924.6	\$ 887.8
Accumulated depreciation.....	(417.6)	(380.1)
	-----	-----
Property and equipment, net.....	\$ 507.0	\$ 507.7
	=====	=====

GOODWILL AND OTHER INTANGIBLES

Goodwill and other intangibles include the cost of acquired subsidiaries in excess of the fair value of the net assets (i.e., goodwill) and other intangible assets which have been recorded in connection with acquisitions. These assets are amortized on a straight-line basis generally over 8 to 40 years. At December 31, 2000, the weighted-average



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

amortization periods for goodwill and other intangibles were 22.4 years and 38.6 years, respectively. The carrying amount of goodwill and other intangibles is reviewed periodically for indicators of impairment in value, which in the view of management are other than temporary, including unexpected or adverse changes in the economic or competitive environments in which the Company operates, profitability analyses and the fair value of the relevant subsidiary. If facts and circumstances suggest that a subsidiary's goodwill is impaired, the Company assesses the fair value of the underlying business and reduces the goodwill to an amount that results in the book value of the subsidiary approximating fair value.

Goodwill and other intangibles, and related accumulated amortization, are as follows (in millions):

	DECEMBER 31,	
	2000	1999
Goodwill.....	\$ 559.0	\$ 610.9
Other intangibles.....	908.0	920.1
	1,467.0	1,531.0
Accumulated amortization.....	(91.1)	(59.5)
Total goodwill and other intangibles, net.....	\$1,375.9	\$1,471.5

PREMIUMS DUE AND OTHER RECEIVABLES

Premiums due and other receivables include life and health insurance premiums due, reinsurance recoveries, guaranty funds receivable or on deposit, receivables from the sale of securities and other receivables.

MORTGAGE LOAN SERVICING RIGHTS

Mortgage loan servicing rights represent the cost of purchasing or originating the right to service mortgage loans. These costs are capitalized and amortized to operations over the estimated remaining lives of the underlying loans using the interest method and taking into account appropriate prepayment assumptions. Capitalized mortgage loan servicing rights are periodically assessed for impairment, which is recognized in the consolidated statements of operations during the period in which impairment occurs by establishing a corresponding valuation allowance. For purposes of performing its impairment evaluation, the Company stratifies the servicing portfolio on the basis of specified predominant risk characteristics, including loan type and note rate. A valuation model is used to determine the fair value of each stratum. Cash flows are calculated using an internal prepayment model and discounted at a spread to London Inter-Bank Offer Rate. External valuations are obtained for comparison purposes. Activity in the valuation allowance for mortgage loan servicing rights is summarized as follows (in millions):

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
Balance at beginning of year.....	\$ 2.9	\$ 56.1	\$ 4.2
Impairments.....	1.1	1.7	120.0
Recoveries.....	(1.7)	(54.9)	(68.1)
Balance at end of year.....	\$ 2.3	\$ 2.9	\$ 56.1

OTHER ASSETS

Included in other assets are certain assets pending transfer or novation that are carried at fair value (see Note 2). The remainder of other assets are reported primarily at cost.

COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) includes all changes in equity during a period except those resulting from investments by shareholders and distributions to shareholders, which would not be applicable to a mutual holding company.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

The following table sets forth the adjustments necessary to avoid duplication of items that are included as part of net income for a year that had been part of other comprehensive income in prior years (in millions):

	DECEMBER 31,		
	2000	1999	1998
Unrealized gains (losses) on available-for-sale securities arising during the year.....	\$238.9	\$(1,013.2)	\$(531.8)
Adjustment for realized gains (losses) on available-for-sale securities included in net income.....	(29.9)	188.2	240.2
Unrealized gains (losses) on available-for-sale securities, as adjusted.....	\$209.0	\$ (825.0)	\$(291.6)

The above adjustment for net realized gains on available-for-sale securities included in net income is presented net of tax, related changes in the amortization patterns of deferred policy acquisition costs and unearned revenue reserves.

RECLASSIFICATIONS

Reclassifications have been made to the 1998 and 1999 consolidated financial statements to conform to the 2000 presentation.

ACCOUNTING CHANGES

In June 1998, the Financial Accounting Standards Board (the "FASB") issued Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133"). In June 1999, Statement No. 137, Accounting for Derivative Instruments and Hedging Activities -- Deferral of the Effective Date of FASB Statement No. 133 ("SFAS 137") was issued deferring the effective date of SFAS 133 by one year. The new effective date for the Company to adopt SFAS 133 is January 1, 2001. In June 2000, the FASB issued Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities an amendment of FASB Statement No. 133 which amended the accounting and reporting standards of SFAS 133 for certain derivative instruments and certain hedging activities. SFAS 133 will require the Company to include all derivatives in the consolidated statement of financial position at fair value. The accounting for changes in the fair value of a derivative depends on its intended use. Changes in derivative fair values will either be recognized in earnings as offsets to the changes in fair value of related hedged assets, liabilities and firm commitments or, for forecasted transactions, deferred and recorded as a component of equity until the hedged transactions occur and are recognized in earnings. The ineffective portion of a hedging derivative's change in fair value will be immediately recognized in earnings. Derivatives not used in hedging activities must be adjusted to fair value through earnings. The Company adopted SFAS 133 effective January 1, 2001. The Company evaluated the effect implementation would have on its reported results of operations and financial position, based on derivatives holdings and market conditions as of December 31, 2000. That evaluation indicated that the implementation of SFAS 133 would not have had a material impact on the results of operations and financial position as of and for the year ended December 31, 2000.

On January 1, 1999, the Company implemented the Statement of Position ("SOP") 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. SOP 98-1 defines internal use software and when the costs associated with internal use should be capitalized. The implementation did not have a material impact on the Company's consolidated financial statements.

In December 2000, the Accounting Standards Executive Committee issued Statement of Position 00-3, Accounting by Insurance Enterprises for Demutualization and Formation of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts. The effective date for adoption of SOP 00-3, with retroactive application and restatement of all previously issued financial statements, is for fiscal years beginning after December 15, 2000, however, early adoption is encouraged by the Accounting Standards Executive Committee. The Statement provides guidance on accounting by insurance companies for demutualization and the formation of mutual insurance holding companies. The Statement specifies that closed block assets, liabilities, revenues and expenses should be displayed together with all other assets, liabilities, revenues and expenses of the insurance enterprise based on the nature of the particular item, with appropriate disclosures relating to the closed block. The Statement also provides guidance regarding: accounting for predemutualization participating contracts, establishment of a policyholder dividend obligation for earnings that relate to the closed block, but do not inure to stockholders, if applicable, accounting for participating policies sold outside the closed block, accounting for expenses related to a demutualization and the formation of an MIHC, accounting for retained earnings and other comprehensive income and accounting for a distribution from an

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED)

MIHC to its members. The Company early adopted SOP 00-3 during 2000, and financial statements for all periods presented have been reclassified to reflect the guidance set forth in SOP 00-3. See Note 6.

## 2. MERGERS, ACQUISITIONS AND DIVESTITURES

During 2000, various acquisitions of joint ventures were made by the Company at purchase prices aggregating \$27.4 million. During 2000, the Company included \$(2) million in net investment income representing the Company's share of current year net losses of the acquired joint ventures. These joint ventures are part of unconsolidated entities described in Note 1.

On December 21, 2000, the Company entered into an agreement to dispose of the stock of Principal International Espana, S.A. de Seguros de Vida, a subsidiary in Spain. The transaction is expected to be completed in the first quarter of 2001, after which the Company will have no business operations in Spain. In 2000, the consolidated financial statements included \$222.7 million in assets, \$49.4 million in revenues and \$(1.2) million of pretax losses related to these operations.

Beginning January 1, 2000, the Company ceased new sales of Medicare supplement insurance and effective July 1, 2000, the Company entered into a reinsurance agreement to reinsure 100% of the Medicare supplement insurance block of business. Medicare supplement insurance premiums were \$98.4 million for the six months ended June 30, 2000 and \$164.6 million for the year ended December 31, 1999.

On August 31, 1999, the Company acquired the outstanding stock of several companies affiliated with Bankers Trust Australia Group ("Acquired Companies") from Deutsche Bank AG at a purchase price of \$1,445.6 million. The acquisition was accounted for using the purchase method and results of operations of the Acquired Companies have been included in the consolidated financial statements from the date of acquisition. In connection with the acquisition, the Company and Deutsche Bank AG agreed to the sale of the investment banking operations of the Acquired Companies to Macquarie Bank Limited, with net proceeds of \$63.7 million from this transaction being included in the acquired assets.

The purchase price and \$9.4 million of direct acquisition costs have been allocated to the assets acquired and liabilities assumed based on their respective fair market values at the acquisition date. The allocation included identifiable intangibles represented by management rights for the funds management business and the brand name of \$897.4 million and \$38.5 million of workforce intangibles, with \$408.6 million of resulting goodwill, which are being amortized on a straight-line basis over 40, 8 and 25 years, respectively. Refinements in the allocation were made in 2000 as accounting completion and valuation studies were finalized.

Completion of the sale of the investment banking operations required the transfer or novation to Macquarie Bank Limited of the investment banking assets and liabilities of the Acquired Companies. The bulk of these were statutorily transferred on August 3, 1999, pursuant to the procedures laid down in the Financial Sector (Transfers of Business) Act ("the Act") of the Commonwealth of Australia. Certain assets and liabilities which are governed by a law other than that of Australia, or which the Act does not address, were excluded from the statutory transfer. For these assets and liabilities it has been necessary to effect individual transfers or novations, in some cases with the agreement of the relevant customers or counterparties. Pending such transfers or novations, the Company agreed, as part of the sale of the investment banking operations, that these assets and liabilities will remain in the name of one of the Acquired Companies, but all economic risks and benefits associated with them will be assumed and a related indemnification provided by Macquarie Bank Limited. In addition, the Company may rely upon Deutsche Bank AG to ensure that the Company does not suffer any claim or loss related to the investment banking operations sold, including the assets and liabilities, respectively, that will remain in the name of the Acquired Companies pending transfer or novation. These assets and liabilities which remain in the name of one of the Acquired Companies and aggregated \$1,020.7 million and \$652.7 million at December 31, 1999, respectively, are reported at fair value and included in other assets and other liabilities in the Company's consolidated statement of financial position, with a net payable to Macquarie Bank Limited of \$368.0 million. At December 31, 2000, these assets and liabilities aggregated \$424.1 million and \$219.6 million, respectively, with a net payable to Macquarie Bank Limited of \$204.5 million.

During 1999, various other acquisitions were made by the Company at purchase prices aggregating \$121.5 million. The acquisitions were all accounted for using the purchase method and the results of operations of the acquired businesses have been included in the financial statements of the subsidiaries from the dates of acquisition. Such acquired companies had total assets at December 31, 1999 and total 1999 revenue of \$126.9 million and \$11.2 million, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 2. MERGERS, ACQUISITIONS AND DIVESTITURES -- (CONTINUED)

Effective April 1, 1998, the Company transferred substantially all of its managed care operations with Coventry Corporation in exchange for a non-majority ownership position in the resulting entity, Coventry Health Care, Inc. The Company's investment in Coventry Health Care, Inc. is accounted for using the equity method. Net equity of the transferred business on April 1, 1998 was \$170.0 million. Consolidated financial results for 1997 included total assets at December 31, 1997, and total revenues and pretax loss for the year then ended of approximately \$419.0 million, \$883.3 million and \$(26.1) million, respectively, for the transferred business. In September 2000, the Company sold a portion of its equity ownership position, which reduced its ownership to approximately 25% and resulted in a realized capital gain of \$13.9 million, net of tax.

During 1998, various acquisitions were made by the Company at purchase prices aggregating \$224.5 million. The acquisitions were all accounted for using the purchase method and the results of operations of the acquired businesses have been included in the financial statements of the subsidiaries from the dates of acquisition. Such acquired companies had total assets at December 31, 1998 and total 1998 revenue of \$458.8 million and \$58.3 million, respectively.

During 1998, various divestitures were made by the Company at selling prices aggregating \$117.9 million and \$15.3 million in net realized capital gains were realized as a result of these divestitures. In 1997, the financial statements included \$151.6 million in assets, \$205.7 million in revenues and \$19.8 million of pretax losses related to these subsidiaries.

Effective July 1, 1998, the Company no longer participates in reinsurance pools related to the Federal Employee Group Life Insurance and Service Group Life Insurance programs. In 1997, the premium assumed from these arrangements was approximately \$84.9 million.

## 3. INVESTMENTS

Under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, securities are generally classified as available-for-sale, held-to-maturity, or trading. The Company has classified its entire fixed maturities portfolio as available-for-sale, although it is generally the Company's intent to hold these securities to maturity. The Company has also classified all equity securities as available-for-sale. Securities classified as available-for-sale are reported at fair value in the consolidated statements of financial position with the related unrealized holding gains and losses on such available-for-sale securities reported as a separate component of equity after adjustments for related changes in deferred policy acquisition costs, unearned revenue reserves and deferred income taxes.

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

3. INVESTMENTS -- (CONTINUED)

The cost, gross unrealized gains and losses and fair value of fixed maturities and equity securities available-for-sale as of December 31, 2000 and 1999, are as follows (in millions):

	COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
	-----	-----	-----	-----
<b>DECEMBER 31, 2000</b>				
Fixed maturities:				
United States Government and agencies.....	\$ 23.2	\$ 0.1	\$ 0.2	\$ 23.1
Foreign governments.....	895.7	27.6	5.3	918.0
States and political subdivisions.....	287.4	12.5	4.2	295.7
Corporate -- public.....	9,027.2	219.5	129.4	9,117.3
Corporate -- private.....	9,809.9	208.9	206.0	9,812.8
Mortgage-backed and other asset-backed securities.....	6,496.1	211.2	34.3	6,673.0
	-----	-----	-----	-----
Total fixed maturities.....	\$26,539.5	\$679.8	\$379.4	\$26,839.9
	=====	=====	=====	=====
Total equity securities.....	\$ 805.9	\$191.2	\$254.2	\$ 742.9
	=====	=====	=====	=====
<b>DECEMBER 31, 1999</b>				
Fixed maturities:				
United States Government and agencies.....	\$ 163.7	\$ --	\$ 1.7	\$ 162.0
Foreign governments.....	820.2	18.7	15.2	823.7
States and political subdivisions.....	176.0	1.3	9.8	167.5
Corporate -- public.....	5,425.4	74.4	140.6	5,359.2
Corporate -- private.....	11,476.9	106.7	363.0	11,220.6
Mortgage-backed and other asset-backed securities.....	5,832.2	12.6	133.9	5,710.9
	-----	-----	-----	-----
Total fixed maturities.....	\$23,894.4	\$213.7	\$664.2	\$23,443.9
	=====	=====	=====	=====
Total equity securities.....	\$ 720.8	\$176.3	\$ 32.9	\$ 864.2
	=====	=====	=====	=====

The cost and fair value of fixed maturities available-for-sale at December 31, 2000, by expected maturity, are as follows (in millions):

	COST	FAIR VALUE
	-----	-----
Due in one year or less.....	\$ 1,125.2	\$ 1,113.0
Due after one year through five years.....	9,782.8	9,783.0
Due after five years through ten years.....	5,273.6	5,352.8
Due after ten years.....	3,861.8	3,918.1
	-----	-----
Mortgage-backed and other asset-backed securities.....	20,043.4	20,166.9
	6,496.1	6,673.0
	-----	-----
Total.....	\$26,539.5	\$26,839.9
	=====	=====

The above summarized activity is based on expected maturities. Actual maturities may differ because borrowers may have the right to call or pre-pay obligations.

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

3. INVESTMENTS -- (CONTINUED)

Major categories of net investment income are summarized as follows (in millions):

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
Fixed maturities, available-for-sale.....	\$1,880.7	\$1,712.4	\$1,587.5
Equity securities, available-for-sale.....	67.6	46.2	31.6
Mortgage loans.....	1,022.9	1,111.1	1,143.0
Real estate.....	171.3	187.5	143.2
Policy loans.....	55.1	50.2	50.9
Cash and cash equivalents.....	32.3	25.9	8.8
Other.....	81.1	55.3	108.1
	-----	-----	-----
	3,311.0	3,188.6	3,073.1
Less investment expenses.....	(138.7)	(116.6)	(139.2)
	-----	-----	-----
Net investment income.....	\$3,172.3	\$3,072.0	\$2,933.9
	=====	=====	=====

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

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
Fixed maturities, available-for-sale:			
Gross gains.....	\$ 29.1	\$ 31.2	\$ 61.4
Gross losses.....	(155.0)	(128.1)	(33.5)
Equity securities, available-for-sale:			
Gross gains.....	84.2	408.7	341.7
Gross losses.....	(5.0)	(25.7)	(38.8)
Mortgage loans.....	8.6	(8.4)	6.3
Real estate.....	82.3	56.4	120.6
Other.....	95.7	70.4	8.1
	-----	-----	-----
Net realized capital gains.....	\$ 139.9	\$ 404.5	\$465.8
	=====	=====	=====

Proceeds from sales of investments (excluding call and maturity proceeds) in fixed maturities were \$5.7 billion, \$5.5 billion and \$2.8 billion in 2000, 1999 and 1998 respectively. Of the 2000, 1999 and 1998 proceeds, \$2.6 billion, \$3.8 billion and \$2.2 billion, respectively, relates to sales of mortgage-backed securities. The Company actively manages its mortgage-backed securities portfolio to control prepayment risk. Gross gains of \$2.0 million, \$2.1 million and \$23.0 million and gross losses of \$40.1 million, \$60.3 million and \$7.0 million in 2000, 1999 and 1998, respectively, were realized on sales of mortgage-backed securities. At December 31, 1999, the Company had security purchases payable totaling \$21.9 million relating to the purchases of mortgage-backed securities at forward dates.

The net unrealized gains and losses on investments in fixed maturities and equity securities available-for-sale is reported as a separate component of equity, reduced by adjustments to deferred policy acquisition costs and unearned revenue reserves that would have been required as a charge or credit to operations had such amounts been realized and a provision for deferred income taxes. The cumulative amount of net unrealized gains and losses on available-for-sale securities is as follows (in millions):

	DECEMBER 31,	
	2000	1999
Net unrealized gains and losses on fixed maturities, available-for-sale.....	\$283.9	\$(437.9)
Net unrealized gains and losses on equity securities, available-for-sale, including seed money in separate accounts.....	(55.6)	229.7
Adjustments for assumed changes in amortization patterns:		
Deferred policy acquisition costs.....	(43.2)	79.4
Unearned revenue reserves.....	2.8	(12.3)
Provision for deferred income (taxes) tax benefit.....	(58.0)	62.0
	-----	-----
Net unrealized gains and losses on available-for-sale securities.....	\$129.9	\$(79.1)
	=====	=====



PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

3. INVESTMENTS -- (CONTINUED)

The corporate private placement bond portfolio is diversified by issuer and industry. Restrictive bond covenants are monitored by the Company to regulate the activities of issuers and control their leveraging capabilities.

Commercial mortgage loans and corporate private placement bonds originated or acquired by the Company represent its primary areas of credit risk exposure. At December 31, 2000 and 1999, the commercial mortgage portfolio is diversified by geographic region and specific collateral property type as follows:

GEOGRAPHIC DISTRIBUTION

	DECEMBER 31,	
	2000	1999
New England.....	5%	5%
Middle Atlantic.....	15	14
East North Central.....	9	10
West North Central.....	4	5
South Atlantic.....	24	25
East South Central.....	4	3
West South Central.....	8	7
Mountain.....	6	5
Pacific.....	26	27
Valuation allowance.....	(1)	(1)

PROPERTY TYPE DISTRIBUTION

	DECEMBER 31,	
	2000	1999
Office.....	30%	31%
Retail.....	34	33
Industrial.....	31	32
Apartments.....	4	3
Hotel.....	1	1
Mixed use/other.....	1	1
Valuation allowance.....	(1)	(1)

Mortgage loans on real estate are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to contractual terms of the loan agreement. When the Company determines that a loan is impaired, a provision for loss is established for the difference between the carrying amount of the mortgage loan and the estimated value. Estimated value is based on either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or fair value of the collateral. The provision for losses is reported as a net realized capital loss.

Mortgage loans deemed to be uncollectible are charged against the allowance for losses and subsequent recoveries are credited to the allowance for losses. The allowance for losses is maintained at a level believed adequate by management to absorb estimated probable credit losses. Management's periodic evaluation of the adequacy of the allowance for losses is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of the underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. The evaluation is inherently subjective as it requires estimating the amounts and timing of future cash flows expected to be received on impaired loans that may change.

A summary of the changes in the mortgage loan allowance for losses is as follows (in millions):

	DECEMBER 31,		
	2000	1999	1998
Balance at beginning of year.....	\$117.8	\$113.0	\$121.4
Provision for losses.....	5.4	9.2	7.3
Releases due to write-downs, sales and foreclosures.....	(12.8)	(4.4)	(15.7)
Balance at end of year.....	\$110.4	\$117.8	\$113.0

The Company was servicing approximately 582,000 and 555,000 residential



mortgage loans with aggregate principal balances of approximately \$55,987.4 million and \$51,875.5 million at December 31, 2000 and 1999, respectively. In connection with these mortgage servicing activities, the Company held funds in trust for others totaling approximately \$343.8 million and \$334.0 million at December 31, 2000 and 1999, respectively. In connection with its loan administration activities, the Company advances payments of property taxes and insurance premiums and also advances principal and interest payments to investors in advance of collecting funds from specific mortgagors. In addition, the Company makes certain payments of attorney fees and other costs related to loans in foreclosure. These amounts receivable are recorded, at cost, as advances on serviced loans. Amounts advanced are considered in management's evaluation of the adequacy of the mortgage loan allowance for losses.

In June 2000, the Company's mortgage banking segment created a special purpose entity to provide an off-balance sheet source of funding for the Company's residential mortgage loan production. The Company sells residential mortgage loans to the special purpose entity, where they are warehoused until sold to the final investor. A maximum of \$1 billion may be warehoused by the special purpose entity at any given time. Through December 31, 2000,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

3. INVESTMENTS -- (CONTINUED)

\$5,340.8 million of loans had been sold to the special purpose entity and \$688.2 million was warehoused by the special purpose entity at December 31, 2000. The Company remains the servicer of the mortgage loans and also performs secondary marketing, accounting and various administrative functions on behalf of the special purpose entity. The special purpose entity is owned by unaffiliated equity certificate holders and thus, is not consolidated with the Company.

In October 2000, the Company's mortgage banking unit also created an unconsolidated qualifying special purpose entity ("QSPE") to provide an off-balance sheet source of funding for up to \$250 million of qualifying delinquent mortgage loans. The Company sells qualifying delinquent loans to the QSPE, which then pledges the loans to secure its borrowings from a Delaware business trust. The trust funds its loan to the QSPE by selling participations certifications to commercial paper conduit purchasers. Mortgage loans remain in the QSPE until they are processed through claims, reinstated or paid off. The Company is retained as the servicer on the mortgage loans and also performs accounting and various administrative functions on behalf of the QSPE. The Company's retained interest in the mortgage loans of \$10.2 million is classified as other assets in the consolidated statements of financial position.

Real estate holdings and related accumulated depreciation are as follows (in millions):

	DECEMBER 31,	
	2000	1999
Investment real estate.....	\$ 822.2	\$1,339.6
Accumulated depreciation.....	(117.1)	(161.0)
	705.1	1,178.6
Properties held for sale.....	695.4	1,033.4
Real estate, net.....	\$1,400.5	\$2,212.0

Other investments primarily include properties owned jointly with venture partners and operated by the partners. Joint ventures in which the Company has an interest have mortgage loans with the Company of \$612.1 million and \$760.1 million at December 31, 2000 and 1999, respectively. The Company is committed to providing additional mortgage financing for such joint ventures aggregating \$71.5 million and \$76.8 million at December 31, 2000 and 1999, respectively.

4. SECURITIZATION TRANSACTIONS

COMMERCIAL MORTGAGE LOANS

During 2000 and 1999, the Company sold commercial mortgage loans in securitization transactions. In each of those securitizations, the Company retained primary servicing responsibilities and other interests. The Company receives annual servicing fees approximating 0.01 percent, which approximates cost. The investors and the securitization trusts have no recourse to the Company's other assets for failure of debtors to pay when due. The value of the Company's retained interests is subject primarily to credit risk.

In 2000, the Company recognized pretax gains of \$0.7 million on the securitization of commercial mortgage loans.

Key economic assumptions used in measuring the retained interests at the date of securitization resulting from transactions completed during the year included a cumulative default rate between five and eight percent. The assumed range of the loss severity, as a percentage of defaulted loans, was between 13 and 25 percent. The low end of the loss severity range relates to a portfolio of seasoned loans. The high end of the loss severity range relates to a portfolio of newly issued loans.

At December 31, 2000, the fair values of retained interests related to the securitizations of commercial mortgage loans were \$65.2 million. Key economic assumptions and the sensitivity of the current fair values of residual cash flows were tested to one and two standard deviations from the expected rates. The changes in the fair values at December 31, 2000 as a result of these assumptions were not significant.

RESIDENTIAL MORTGAGE LOANS

During 2000 and 1999, the Company sold residential mortgage loans in securitization transactions. In those securitizations, the Company retained servicing responsibilities and subordinated interests. The Company receives annual servicing fees approximating 0.4 percent of the outstanding balance and rights to future cash flows arising after

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

4. SECURITIZATION TRANSACTIONS -- (CONTINUED)

the investors have received the return for which they have contracted. The investors have no recourse to the Company's other assets for failure of debtors to pay when due. The Company's retained interests are subordinate to the investor's interests. Their value is subject to prepayment and interest rate risks on the transferred assets.

In 2000, the Company recognized pretax gains of \$9.4 million on the securitization of residential mortgage loans.

The key economic assumptions used in determining the fair value of mortgage servicing rights at the date of securitization resulting from securitizations completed in 2000 were as follows:

Weighted average life (years).....	6.87
Prepayment speed.....	11.81%
Static yield to maturity discount rate.....	10.74%

Prepayment speed is the constant prepayment rate that results in the weighted average life disclosed above.

At December 31, 2000, key economic assumptions and the sensitivity of the current fair value of the mortgage servicing rights to immediate 10 and 20 percent adverse changes in those assumptions are as follows (\$ in millions):

Fair value of retained interests.....	\$1,193.4
Expected weighted average life (in years).....	6.7
Prepayment speed.....	12.43%
Decrease in fair value of 10% adverse change.....	\$ 45.7
Decrease in fair value of 20% adverse charge.....	\$ 87.1
Static yield to maturity discount rate.....	9.44%
Decrease in fair value of 10% adverse change.....	\$ 73.8
Decrease in fair value of 20% adverse change.....	\$ 147.7

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10% variation in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, in the above table, the effect of a variation in a particular assumption on the fair value of the servicing rights is calculated independently without changing any other assumption. In reality, changes in one factor may result in change in another, which might magnify or counteract the sensitivities. For example, changes in prepayment speed estimates could result in changes in the discount rate.

MARGIN LENDING

During 2000 and 1999, the Company sold loans under its margin loan securitization program. In that securitization, the Company retained primary servicing responsibilities and retained subordinated interests. The Company receives servicing fees approximating 0.3 percent of the outstanding balance and rights to future cash flows arising after investors in the trust have received a contracted return. The Company's retained interests are subordinated to investors' interests. Retained interests equate to 7% of the outstanding loan balances, of which the Company may earn a return of 1.5% to 2.0% over the Australian 30 day Bank Bill swap rate. The investors and the securitization trusts have no recourse to the Company's other assets for failure of debtors to pay when due. The value of the Company's retained interests is subject to market risk and all positions are primarily hedged. No gains or losses on the transaction have been realized to date.

The fair values of the retained interests, \$43.7 million at December 31, 2000, are based upon the Company's relative ownership percentage of the outstanding loan balances. At December 31, 2000, the Company utilized the present value of expected future cash flows as a valuation technique to assess the sensitivity of the fair values of retained interests. Key economic assumptions used in measuring the retained interests included interest margin, credit losses, terminations and discount rates and the resulting changes to the fair values were not significant.

The table below summarizes cash flows received from and paid to securitization trusts for the year ended December 31, 2000 (in millions):

Proceeds from new securitizations.....	\$9,658.2
Proceeds from advances on margin loans previously securitized.....	16.1
Servicing fees received.....	239.3
Other cash flows received on retained interests.....	42.8

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 5. DERIVATIVES HELD OR ISSUED FOR PURPOSES OTHER THAN TRADING

The Company uses exchange-traded interest rate futures and mortgage-backed securities forwards to hedge against interest rate risks. The Company attempts to match the timing of when interest rates are committed on insurance products and on new investments. However, timing differences do occur and can expose the Company to fluctuating interest rates. Interest rate futures and mortgage-backed securities forwards are used to minimize these risks. In these contracts, the Company is subject to the risk that the counterparties will fail to perform and to the risks associated with changes in the value of the underlying securities; however, such changes in value generally are offset by opposite changes in the value of the hedged items. Futures contracts are marked to market and settled daily, which minimizes the counterparty risk. The notional amounts of futures contracts represent the extent of the Company's involvement.

The Company uses interest rate swaps to more closely match the interest rate characteristics of its assets with those of its liabilities. Swaps are used in asset and liability management to modify duration and match cash flows. Occasionally, the Company will sell a callable investment-type contract and may use interest rate swaptions or similar instruments to transform the callable liability into a fixed term liability. In addition, the Company may sell an investment-type contract with attributes tied to market indices in which case the Company uses a call option to transform the liability into a fixed rate liability. The Company's current credit exposure on swaps is limited to the value of interest rate swaps that have become favorable to the Company. The average unexpired terms of the swaps were approximately four years at December 31, 2000 and five years at December 31, 1999. The net amount payable or receivable from interest rate swaps is accrued as an adjustment to interest income. The Company's interest rate swap agreements include cross-default provisions when two or more swaps are transacted with a given counterparty.

The Company enters into currency exchange swap agreements to convert both principal and interest payments of certain foreign denominated fixed rate assets and liabilities into U.S. dollar denominated instruments to eliminate the exposure to future currency volatility on those items. At December 31, 2000, the Company had various foreign currency exchange agreements with maturities ranging from 2001 to 2019. At December 31, 1999, such maturities ranged from 2000 to 2018. The average unexpired term of the swaps was approximately five years at December 31, 2000 and six years at December 31, 1999.

The Company manages the risk on its commercial mortgage loan pipeline by buying and selling mortgage-backed securities in the forward markets, interest rate swaps, interest rate futures, and treasury rate guarantees. Such futures contracts are marked to market and settled daily.

The Company manages risk on its residential mortgage loan pipeline by buying and selling mortgage-backed securities in the forward markets, over-the-counter options on mortgage-backed securities, U.S. Treasury futures contracts and options on Treasury futures contracts. The Company entered into mandatory forward, option and futures contracts to reduce interest rate risk on certain mortgage loans held for sale and other commitments. The forward contracts provide for the delivery of securities at a specified future date at a specified price or yield. In the event the counterparty is unable to meet its contractual obligations, the Company may be exposed to the risk of selling mortgage loans at prevailing market prices. The effect of these contracts was considered in the lower of cost or market calculation of mortgage loans held for sale.

The Company has committed to originate approximately \$695.2 million and \$372.0 million of residential mortgage loans at December 31, 2000 and 1999, respectively, subject to borrowers meeting the Company's underwriting guidelines. These commitments call for the Company to fund such loans at a future date with a specified rate at a specified price. Because the borrowers are not obligated to close the loans, the Company is exposed to risks that it may not have sufficient mortgage loans to deliver to its mandatory forward contracts and, thus, would be obligated to purchase mortgage loans at prevailing market rates to meet such commitments. Conversely, the Company is exposed to the risk that more loans than expected will close, and the loans would then be sold at current market prices.

The Company uses interest rate floors, futures contracts and options on futures contracts in hedging a portion of its portfolio of mortgage servicing rights from prepayment risk associated with changes in interest rates. The floors and contracts provide for the receipt of payments when interest rates are below predetermined interest rate levels. The premiums paid for floors are included in other assets in the Company's consolidated statements of financial position.

With regard to its international operations, the Company attempts to conduct much of its business in the functional currency of the country of operation. At times, the Company is unable to do so and it uses foreign currency forwards, foreign currency swaps and interest rate swaps to hedge the resulting currency risk.

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

5. DERIVATIVES HELD OR ISSUED FOR PURPOSES OTHER THAN TRADING -- (CONTINUED)

The notional amounts and credit exposure of the Company's derivative financial instruments by type are as follows (in millions):

	DECEMBER 31,	
	2000	1999
	-----	-----
NOTIONAL AMOUNTS OF DERIVATIVE INSTRUMENTS WITH REGARD TO UNITED STATES OPERATIONS		
Foreign currency swaps.....	\$ 2,745.0	\$ 1,571.5
Interest rate floors.....	2,450.0	5,550.0
Interest rate swaps.....	2,391.5	1,298.5
Mortgage-backed forwards and options.....	1,898.3	1,546.7
Swaptions.....	697.7	469.7
Call options.....	30.0	30.0
U.S. Treasury futures.....	183.2	287.6
Currency forwards.....	39.4	13.0
Treasury rate guarantees.....	60.0	--
	-----	-----
	10,495.1	10,767.0
NOTIONAL AMOUNTS OF DERIVATIVE INSTRUMENTS WITH REGARD TO INTERNATIONAL OPERATIONS		
Foreign currency swaps.....	665.0	670.0
Interest rate swaps.....	665.0	665.0
Currency forwards.....	380.0	380.0
	-----	-----
	1,710.0	1,715.0
	-----	-----
Total notional amounts at end of year.....	\$12,205.1	\$12,482.0
	=====	=====
CREDIT EXPOSURE OF DERIVATIVE INSTRUMENTS WITH REGARD TO UNITED STATES OPERATIONS		
Foreign currency swaps.....	\$ 45.3	\$ 69.2
Interest rate floors.....	20.0	15.1
Interest rate swaps.....	14.1	21.6
Mortgage-backed forwards and options.....	--	6.0
Swaptions.....	11.8	8.7
Call options.....	12.3	19.0
Currency forwards.....	5.5	--
	-----	-----
	109.0	139.6
CREDIT EXPOSURE OF DERIVATIVE INSTRUMENTS WITH REGARD TO INTERNATIONAL OPERATIONS		
Foreign currency swaps.....	28.4	14.8
Interest rate swaps.....	39.1	--
Currency forwards.....	26.2	--
	-----	-----
	93.7	14.8
	-----	-----
Total credit exposure at end of year.....	\$ 202.7	\$ 154.4
	=====	=====

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

6. CLOSED BLOCK

Summarized financial information of the Closed Block is as follows (in millions):

	DECEMBER 31,	
	2000	1999
<b>ASSETS</b>		
Fixed maturities, available-for-sale.....	\$2,182.2	\$1,781.7
Mortgage loans.....	919.4	1,035.9
Policy loans.....	770.0	752.1
Other investments.....	1.3	1.2
Total investments.....	3,872.9	3,570.9
Cash and cash equivalents.....	22.7	23.9
Accrued investment income.....	72.4	62.9
Deferred policy acquisition costs.....	524.7	639.1
Premiums due and other receivables.....	33.7	41.5
	\$4,526.4	\$4,338.3
	=====	=====
<b>LIABILITIES</b>		
Future policy benefits and claims.....	\$5,051.4	\$4,885.2
Other policyholder funds.....	406.9	405.8
Other liabilities.....	108.5	124.5
	\$5,566.8	\$5,415.5
	=====	=====

	YEAR ENDED DECEMBER 31,	
	2000	1999
<b>REVENUES AND EXPENSES</b>		
Premiums and other considerations.....	\$ 752.5	\$ 764.4
Net investment income.....	289.9	269.3
Other income (expense).....	(5.0)	(2.0)
Benefits, claims and settlement expenses.....	(601.2)	(614.5)
Dividends to policyholders.....	(307.7)	(295.9)
Operating expenses.....	(77.8)	(110.6)
Contribution from Closed Block (before income taxes).....	\$ 50.7	\$ 10.7
	=====	=====

As described in Note 1, the formation of the closed block required an actuarial calculation including expectations of future earnings related to policies in the closed block. Subsequent to formation, cumulative actual earnings in excess of cumulative expected earnings (which are not revised in future periods) are required to be recorded as a policyholder dividend obligation. From date of formation through December 31, 2000, cumulative actual earnings have been less than cumulative expected earnings, and the resulting negative policyholder dividend obligation balance has not been recognized.

7. DEFERRED POLICY ACQUISITION COSTS

Policy acquisition costs deferred and amortized in 2000, 1999 and 1998 are as follows (in millions):

	DECEMBER 31,		
	2000	1999	1998
Balance at beginning of year.....	\$1,430.9	\$1,104.7	\$1,057.5
Cost deferred during the year.....	263.9	253.9	229.0
Amortized to expense during the year.....	(238.6)	(173.8)	(218.9)
Effect of unrealized (gains) losses.....	(122.9)	246.1	37.1
Balance at end of year.....	\$1,333.3	\$1,430.9	\$1,104.7
	=====	=====	=====

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

8. INSURANCE LIABILITIES

Major components of contractholder funds in the consolidated statements of financial position, are summarized as follows (in millions):

	DECEMBER 31,	
	2000	1999
Liabilities for investment-type contracts:		
Guaranteed investment contracts.....	\$14,779.6	\$15,935.5
U.S. funding agreements.....	772.1	742.9
International funding agreements backing medium-term notes.....	2,475.3	1,139.0
Other investment-type contracts.....	2,537.0	3,117.1
Total liabilities for investment-type contracts....	20,564.0	20,934.5
Liabilities for individual annuities.....	2,442.7	2,522.3
Universal life and other reserves.....	1,293.5	1,063.0
Total contractholder funds.....	\$24,300.2	\$24,519.8

The Company's guaranteed investment contracts and funding agreements contain provisions limiting early surrenders, including penalties for early surrenders and minimum notice requirements. Put provisions give customers the option to terminate a contract prior to maturity, provided they give us a minimum notice period.

The following table presents GAAP reserves for guaranteed investment contracts and funding agreements by withdrawal provisions (in millions):

	DECEMBER 31, 2000	
	GUARANTEED INVESTMENT CONTRACTS	FUNDING AGREEMENTS
Less than 30 days notice.....	\$ --	\$ --
30 to 89 days notice.....	284.6	100.6
90 to 180 days notice.....	456.8	226.2
More than 180 days notice.....	--	150.9
No active put provision*.....	426.7	--
No put provision.....	13,611.5	2,769.7
Total.....	\$14,779.6	\$3,247.4

\* Contracts under an initial lock-out period, but which will become puttable with 90 days notice at some time in the future.

Funding agreements are issued to non-qualified institutional investors both in domestic and international markets. In late 1998, the Company established a \$2.0 billion program, which was expanded to \$4.0 billion in 2000, under which an offshore special purpose entity was created to issue nonrecourse medium-term notes. Under the program, the proceeds of each note series issuance are used to purchase a funding agreement from the Company, with the funding agreement so purchased then used to secure that particular series of notes. The payment terms of any particular series of notes match the payment terms of the funding agreement that secures that series. Claims for principal and interest under those international funding agreements are afforded equal priority to claims of life insurance and annuity policyholders under insolvency provisions of Iowa Insurance Laws. During 1999, the Company began issuing international funding agreements to the offshore special purpose vehicle under that program. The offshore special purpose vehicle issued medium-term notes to investors in Europe, Asia and Australia. In general, the medium-term note funding agreements do not give the contractholder the right to terminate prior to contractually stated maturity dates, absent the existence of certain circumstances which are largely within the Company's control. The special purpose entity is consolidated in the Company's financial statements. The medium-term notes issued by the special purpose entity are reported with contractholder funds liabilities in the Company's consolidated statement of financial position. At December 31, 2000, the contractual maturities were 2002 -- \$164.3 million; 2003 -- \$476.6 million; 2004 -- \$424.9 million; and thereafter -- \$1,409.5 million.

In February 2001, the Company agreed to issue up to \$3.0 billion of funding agreements under another program to support the prospective issuance by an unaffiliated entity of medium-term notes in both domestic and international markets. The unaffiliated entity will not be consolidated in the Company's financial statements. The funding agreements





NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

8. INSURANCE LIABILITIES -- (CONTINUED)

issued to the unaffiliated entity will be reported as contractholder funds liabilities in the Company's consolidated statement of financial position.

Activity in the liability for unpaid accident and health claims, which is included with future policy benefits and claims in the consolidated statements of financial position, is summarized as follows (in millions):

	DECEMBER 31,		
	2000	1999	1998
Balance at beginning of year.....	\$ 721.7	\$ 641.4	\$ 770.3
Incurring:			
Current year.....	1,788.1	1,872.2	1,921.8
Prior years.....	(17.8)	(6.2)	(13.8)
Total incurred.....	1,770.3	1,866.0	1,908.0
Reclassification for subsidiary merger (see Note 2).....	--	--	154.9
Payments:			
Current year.....	1,447.3	1,466.3	1,523.1
Prior years.....	339.7	319.4	358.9
Total payments.....	1,787.0	1,785.7	2,036.9
Balance at end of year:			
Current year.....	340.8	405.9	348.7
Prior years.....	364.2	315.8	292.7
Total balance at end of year.....	\$ 705.0	\$ 721.7	\$ 641.4

The activity summary in the liability for unpaid accident and health claims shows a decrease of \$17.8 million, \$6.2 million and \$13.8 million to the December 31, 1999, 1998 and 1997 liability for unpaid accident and health claims, respectively, arising in prior years. Such liability adjustments, which affected current operations during 2000, 1999 and 1998, respectively, resulted from developed claims for prior years being different than were anticipated when the liabilities for unpaid accident and health claims were originally estimated. These trends have been considered in establishing the current year liability for unpaid accident and health claims.

9. DEBT

SHORT-TERM DEBT

Short-term debt consists primarily of commercial paper and outstanding balances on credit facilities with various banks. At December 31, 2000, the Company and certain subsidiaries had credit facilities with various banks in an aggregate amount of \$1.7 billion. The credit facilities may be used for general corporate purposes and also to provide backup for the Company's commercial paper programs.

The components of short-term debt as of December 31, 2000 and 1999 are as follows (in millions):

	DECEMBER 31,	
	2000	1999
Commercial paper.....	\$ 29.9	\$198.5
Other recourse short-term debt.....	16.6	100.0
Non-recourse short-term debt.....	413.0	248.8
Total short-term debt.....	\$459.5	\$547.3

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

9. DEBT -- (CONTINUED)

LONG-TERM DEBT

The components of long-term debt as of December 31, 2000 and December 31, 1999 are as follows (in millions):

	DECEMBER 31,	
	2000	1999
	-----	-----
7.95% notes payable, due 2004.....	\$ 199.3	\$ 198.6
8.2% notes payable, due 2009.....	464.9	460.5
7.875% surplus notes payable, due 2024.....	198.9	199.0
8% surplus notes payable, due 2044.....	99.1	98.8
Non-recourse mortgages and notes payable.....	149.8	335.2
Other mortgages and notes payable.....	224.5	200.8
	-----	-----
Total long-term debt.....	\$1,336.5	\$1,492.9
	=====	=====

The amounts included above are net of the discount and direct costs associated with issuing these notes which are being amortized to expense over their respective terms using the interest method.

On August 25, 1999, Principal Financial Group (Australia) Holdings Pty Limited, a wholly-owned subsidiary of the Company, issued \$665.0 million of unsecured redeemable long-term debt (\$200.0 million of 7.95% notes due August 15, 2004 and \$465.0 million in 8.2% notes due August 15, 2009). Interest on the notes is payable semiannually on February 15 and August 15 of each year, commencing February 15, 2000. Principal Financial Group (Australia) Holdings Pty Limited used the net proceeds from the notes to partially fund the purchase of the outstanding stock of several companies affiliated with Bankers Trust Australia Group (see Note 2).

On March 10, 1994, Principal Life issued \$300.0 million of surplus notes, including \$200.0 million due March 1, 2024 at a 7.875% annual interest rate and the remaining \$100.0 million due March 1, 2044 at an 8% annual interest rate. No affiliates of the Company hold any portion of the notes. Each payment of interest and principal on the notes, however, may be made only with the prior approval of the Commissioner of Insurance of the State of Iowa (the "Commissioner") and only to the extent that Principal Life has sufficient surplus earnings to make such payments. For each of the years ended December 31, 2000, 1999 and 1998, interest of \$24.0 million was approved by the Commissioner, paid and charged to expense.

Subject to Commissioner approval, the surplus notes due March 1, 2024 may be redeemed at Principal Life's election on or after March 1, 2004 in whole or in part at a redemption price of approximately 103.6% of par. The approximate 3.6% premium is scheduled to gradually diminish over the following ten years. These surplus notes may then be redeemed on or after March 1, 2014, at a redemption price of 100% of the principal amount plus interest accrued to the date of redemption.

In addition, subject to Commissioner approval, the notes due March 1, 2044 may be redeemed at Principal Life's election on or after March 1, 2014, in whole or in part at a redemption price of approximately 102.3% of par. The approximate 2.3% premium is scheduled to gradually diminish over the following ten years. These notes may be redeemed on or after March 1, 2024, at a redemption price of 100% of the principal amount plus interest accrued to the date of redemption.

The mortgages and other notes payable are financings for real estate developments. The Company has obtained loans with various lenders to finance these developments. Outstanding principal balances as of December 31, 2000 range from \$0.5 million to \$102.8 million per development with interest rates generally ranging from 6.9% to 8.6%. Outstanding principal balances as of December 31, 1999 range from \$0.6 million to \$38.3 million per development with interest rates generally ranging from 6.4% to 9.3%.

At December 31, 2000, future annual maturities of the long-term debt are as follows (in millions):

2001.....	\$ 118.9
2002.....	94.6
2003.....	8.6
2004.....	202.2
2005.....	3.0
Thereafter.....	909.2
	-----
Total future maturities of the long-term debt.....	\$1,336.5
	=====

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

9. DEBT -- (CONTINUED)

Cash paid for interest for 2000, 1999 and 1998 was \$116.8 million, \$127.7 million and \$96.9 million, respectively. These amounts include interest paid on taxes during these years.

10. INCOME TAXES

The Company's income tax expense (benefit) is as follows (in millions):

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
Current income taxes:			
Federal.....	\$167.7	\$ 74.9	\$(80.6)
State and foreign.....	37.3	23.2	10.2
Net realized capital gains.....	29.6	162.8	106.7
Total current income taxes.....	234.6	260.9	36.3
Deferred income taxes.....	5.7	62.6	5.9
Total income taxes.....	\$240.3	\$323.5	\$ 42.2

The Company's provision for income taxes may not have the customary relationship of taxes to income. Differences between the prevailing corporate income tax rate of 35% times the pre-tax income and the Company's effective tax rate on pre-tax income are generally due to inherent differences between income for financial reporting purposes and income for tax purposes, and the establishment of adequate provisions for any challenges of the tax filings and tax payments to the various taxing jurisdictions. A reconciliation between the corporate income tax rate and the effective tax rate is as follows:

	YEAR ENDED DECEMBER 31,		
	2000	1999	1998
Statutory corporate tax rate.....	35%	35%	35%
Dividends received deduction.....	(5)	(3)	(4)
Interest exclusion from taxable income.....	(1)	--	(1)
Resolution of prior year tax issues.....	--	--	(20)
Other.....	(1)	(2)	(4)
Effective tax rate.....	28%	30%	6%

Significant components of the Company's net deferred income taxes are as follows (in millions):

	DECEMBER 31,	
	2000	1999
Deferred income tax assets (liabilities):		
Insurance liabilities.....	\$ 181.1	\$ 241.7
Deferred policy acquisition costs.....	(360.1)	(358.7)
Net unrealized losses (gains) on available for sale securities.....	(59.1)	91.4
Mortgage loan servicing rights.....	(206.3)	(209.7)
Other.....	(6.6)	24.1
	\$(451.0)	\$(211.2)

At December 31, 2000 and 1999, respectively, the Company's net deferred tax liability is comprised of international net deferred tax assets of \$36.4 million and \$60.5 million which have been included in other assets and \$487.4 million and \$271.7 million of U.S. net deferred tax liabilities which have been included in deferred income taxes in the statements of financial position.

The Internal Revenue Service ("the Service") has completed examination of the U.S. consolidated federal income tax returns for 1996 and prior years. The Service has also begun to examine returns for 1997 and 1998. The Company believes that there are adequate defenses against or sufficient provisions for any challenges.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

10. INCOME TAXES -- (CONTINUED)

Undistributed earnings of certain foreign subsidiaries are considered indefinitely reinvested by the Company. A tax liability will be recognized when the Company expects distribution of earnings in the form of dividends, sale of the investment or otherwise.

Cash paid for income taxes was \$279.3 million in 2000, \$251.5 million in 1999 and \$308.8 million in 1998.

11. EMPLOYEE AND AGENT BENEFITS

The Company has defined benefit pension plans covering substantially all of its employees and certain agents. The employees and agents are generally first eligible for the pension plans when they reach age 21. The pension benefits are based on the years of service and generally the employee's or agent's average annual compensation during the last five years of employment. Partial benefit accrual of pension benefits is recognized from first eligibility until retirement based on attained service divided by potential service to age 65 with a minimum of 35 years of potential service. The Company's policy is to fund the cost of providing pension benefits in the years that the employees and agents are providing service to the Company. The Company's funding policy is to deposit an amount within the range of GAAP net periodic postretirement cost and the sum of actuarial normal cost and any change in the unfunded accrued liability over a 30-year period as a percentage of compensation.

The Company also provides certain health care, life insurance and long-term care benefits for retired employees. Substantially all employees are first eligible for these postretirement benefits when they reach age 57 and have completed ten years of service with the Company. Partial benefit accrual of these health, life and long-term care benefits is recognized from the employee's date of hire until retirement based on attained service divided by potential service to age 65 with a minimum of 35 years of potential service. The Company's policy is to fund the cost of providing retiree benefits in the years that the employees are providing service to the Company. The Company's funding policy is to deposit the actuarial normal cost and an accrued liability over a 30-year period as a percentage of compensation.

The plans' combined funded status, reconciled to amounts recognized in the consolidated statements of financial position and consolidated statements of operations, is as follows (in millions):

	PENSION BENEFITS			OTHER POSTRETIREMENT BENEFITS		
	DECEMBER 31,			DECEMBER 31,		
	2000	1999	1998	2000	1999	1998
<b>CHANGE IN BENEFIT OBLIGATION</b>						
Benefit obligation at beginning of year.....	\$ (732.5)	\$ (827.3)	\$ (700.5)	\$ (227.9)	\$ (206.3)	\$ (213.7)
Service cost.....	(35.0)	(42.2)	(33.8)	(10.4)	(10.9)	(12.1)
Interest cost.....	(57.5)	(55.1)	(49.3)	(19.0)	(14.1)	(15.9)
Actuarial gain (loss).....	(2.7)	163.4	(79.7)	3.7	(3.5)	20.5
Benefits paid.....	30.4	28.7	36.0	--	6.9	14.9
Other.....	--	--	--	31.8	--	--
Benefit obligation at end of year.....	<u>\$ (797.3)</u>	<u>\$ (732.5)</u>	<u>\$ (827.3)</u>	<u>\$ (221.8)</u>	<u>\$ (227.9)</u>	<u>\$ (206.3)</u>
<b>CHANGE IN PLAN ASSETS</b>						
Fair value of plan assets at beginning of year.....	\$ 1,059.8	\$ 992.9	\$ 980.1	\$ 345.5	\$ 325.7	\$ 300.2
Actual return on plan assets.....	75.1	90.1	23.3	13.7	5.4	14.6
Employer contribution.....	10.9	5.5	25.5	18.6	21.3	25.8
Benefits paid.....	(30.4)	(28.7)	(36.0)	(18.0)	(6.9)	(14.9)
Fair value of plan assets at end of year.....	<u>\$ 1,115.4</u>	<u>\$ 1,059.8</u>	<u>\$ 992.9</u>	<u>\$ 359.8</u>	<u>\$ 345.5</u>	<u>\$ 325.7</u>
Funded status.....	\$ 318.1	\$ 327.3	\$ 165.6	\$ 138.0	\$ 117.6	\$ 119.4
Unrecognized net actuarial gain.....	(194.2)	(215.5)	(38.2)	(19.4)	(46.3)	(70.3)
Unrecognized prior service cost.....	9.2	10.9	12.6	(29.8)	--	--
Unamortized transition obligation (asset).....	(14.2)	(25.7)	(37.2)	0.3	4.7	7.8
Other assets -- prepaid benefit cost.....	<u>\$ 118.9</u>	<u>\$ 97.0</u>	<u>\$ 102.8</u>	<u>\$ 89.1</u>	<u>\$ 76.0</u>	<u>\$ 56.9</u>
<b>WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31</b>						
Discount rate.....	8.00%	8.00%	6.75%	8.00%	8.00%	6.75%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

11. EMPLOYEE AND AGENT BENEFITS -- (CONTINUED)

	PENSION BENEFITS			OTHER POSTRETIREMENT BENEFITS		
	DECEMBER 31,			DECEMBER 31,		
	2000	1999	1998	2000	1999	1998
<b>COMPONENTS OF NET PERIODIC BENEFIT COST</b>						
Service cost.....	\$ 35.0	\$ 42.2	\$ 33.8	\$ 10.4	\$ 10.9	\$ 12.1
Interest cost.....	57.5	55.1	49.3	19.0	14.1	15.9
Expected return on plan assets.....	(81.3)	(76.0)	(74.4)	(25.1)	(23.7)	(16.1)
Amortization of prior service cost.....	1.7	1.7	1.7	--	--	--
Amortization of transition (asset) obligation.....	(11.5)	(11.5)	(11.5)	2.3	3.7	3.3
Recognized net actuarial loss (gain).....	(12.5)	(0.3)	(8.3)	(1.1)	(2.3)	(1.8)
Net periodic benefit cost (income).....	<u>\$ (11.1)</u>	<u>\$ 11.2</u>	<u>\$ (9.4)</u>	<u>\$ 5.5</u>	<u>\$ 2.7</u>	<u>\$ 13.4</u>

Effective January 1, 2000, the Company amended the method in determining postretirement health benefit plan and terminated long-term care coverage for participants retiring on and subsequent to July 1, 2000. The result of these amendments decreased the postretirement benefit obligation by \$31.8 million and was partially offset by the remaining portion of the original transition obligation.

For 2000, 1999 and 1998, the expected long-term rates of return on plan assets for pension benefits were approximately 5% in each of these years (after estimated income taxes) for those trusts subject to income taxes. For trusts not subject to income taxes, the expected long-term rates of return on plan assets were approximately 8.1% in each of the years 2000, 1999 and 1998. The assumed rate of increase in future compensation levels varies by age for both the qualified and non-qualified pension plans.

For 2000, 1999 and 1998, the expected long-term rates of return on plan assets for other post-retirement benefits were approximately 5% to 5.9% in each of these years (after estimated income taxes) for those trusts subject to income taxes. For trusts not subject to income taxes, the expected long-term rates of return on plan assets were approximately 9.3%, 8.0% and 8.1% for 2000, 1999 and 1998, respectively. These rates of return on plan assets vary by benefit type and employee group.

The assumed health care cost trend rate used in measuring the accumulated postretirement benefit obligations starts at 13.9% in 2000 and declines to an ultimate rate of 6% in 2010. Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects (in millions):

	1-PERCENTAGE- POINT INCREASE	1-PERCENTAGE- POINT DECREASE
Effect on total of service and interest cost components.....	\$ 7.4	\$ (5.5)
Effect on accumulated postretirement benefit obligation.....	47.7	(38.6)

In addition, the Company has defined contribution plans that are generally available to all employees and agents who are age 21 or older. Eligible participants may contribute up to 20% of their compensation, to a maximum of \$10,500 in 2000 and \$10,000 in 1999 and 1998. The Company matches the participant's contribution at a 50% contribution rate up to a maximum Company contribution of 3% of the participant's compensation in 2000, and 2% of the participant's compensation in 1999 and 1998. The Company contributed \$16.0 million in 2000 and \$11.0 million in both 1999 and 1998 to these defined contribution plans.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

12. OTHER COMMITMENTS AND CONTINGENCIES

The Company, as a lessor, leases industrial, office, retail and other investment real estate properties under various operating leases. Rental income for all operating leases totaled \$292.5 million in 2000, \$356.8 million in 1999 and \$362.4 million in 1998. At December 31, 2000, future minimum annual rental commitments under these noncancelable operating leases are as follows (in millions):

	HELD FOR SALE	HELD FOR INVESTMENT	TOTAL RENTAL COMMITMENTS
	-----	-----	-----
2001.....	\$ 85.4	\$ 87.8	\$ 173.2
2002.....	80.4	80.4	160.8
2003.....	72.5	66.2	138.7
2004.....	63.9	56.0	119.9
2005.....	54.2	46.1	100.3
Thereafter.....	168.2	308.6	476.8
	-----	-----	-----
Total future minimum lease receipts.....	\$524.6	\$645.1	\$1,169.7
	=====	=====	=====

The Company, as a lessee, leases office space, data processing equipment, corporate aircraft and office furniture and equipment under various operating leases. Rental expense for all operating leases totaled \$66.3 million in 2000, \$78.5 million in 1999 and \$60.8 million in 1998. At December 31, 2000, future minimum annual rental commitments under these noncancelable operating leases are as follows (in millions):

2001.....	\$ 49.1
2002.....	40.5
2003.....	32.3
2004.....	25.2
2005.....	16.4
Thereafter.....	12.1
	-----
	175.6
Less future sublease rental income on these noncancelable leases.....	1.1
	-----
Total future minimum lease payments.....	\$174.5
	=====

The Company is a plaintiff or defendant in actions arising out of its operations. The Company is, from time to time, also involved in various governmental and administrative proceedings. While the outcome of any pending or future litigation cannot be predicted, management does not believe that any pending litigation will have a material adverse effect on the Company's business, financial condition or results of operations. However, no assurances can be given that such litigation would not materially and adversely affect the Company's business, financial condition or results of operations.

Other companies in the life insurance industry have historically been subject to substantial litigation resulting from claims disputes and other matters. Most recently, such companies have faced extensive claims, including class-action lawsuits, alleging improper life insurance sales practices. Negotiated settlements of such class-action lawsuits have had a material adverse effect on the business, financial condition and results of operations of certain of these companies. Principal Life is currently a defendant in two class-action lawsuits which allege improper sales practices.

In 2000, the Company reached an agreement in principle to settle these two class-action lawsuits alleging improper sales practices. The proposed settlement is subject to court approval and therefore is not yet final. In agreeing to the settlement, the Company specifically denied any wrongdoing. The Company has accrued a loss reserve for its best estimate based on information available. As uncertainties continue to exist in resolving this matter, it is reasonably possible that, as the actual cost of the claims subject to alternative dispute resolution becomes available, the final cost of settlement could exceed the Company's estimate. However, the range of any additional cost related to the settlement cannot presently be reasonably estimated. See Note 16.

The Company is also subject to insurance guaranty laws in the states in which it writes business. These laws provide for assessments against insurance companies for the benefit of policyholders and claimants in the event of insolvency of other insurance companies. The assessments may be partially recovered through a reduction in future premium taxes in some states. The Company believes such assessments in excess of amounts accrued would not materially affect its financial condition or results of operations.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 13. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following discussion describes the methods and assumptions utilized by the Company in estimating its fair value disclosures for financial instruments. Certain financial instruments, particularly policyholder liabilities other than investment-type contracts, are excluded from these fair value disclosure requirements. The techniques utilized in estimating the fair values of financial instruments are affected by the assumptions used, including discount rates and estimates of the amount and timing of future cash flows. Care should be exercised in deriving conclusions about the Company's business, its value or financial position based on the fair value information of financial instruments presented below. The estimates shown are not necessarily indicative of the amounts that would be realized in a one-time, current market exchange of all of the Company's financial instruments.

The Company defines fair value as the quoted market prices for those instruments that are actively traded in financial markets. In cases where quoted market prices are not available, fair values are estimated using present value or other valuation techniques. The fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, including estimates of timing, amount of expected future cash flows and the credit standing of counterparties. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In many cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument.

Fair values of public debt and equity securities have been determined by the Company from public quotations, when available. Private placement securities and other fixed maturities and equity securities are valued by discounting the expected total cash flows. Market rates used are applicable to the yield, credit quality and average maturity of each security.

Fair values of commercial mortgage loans are determined by discounting the expected total cash flows using market rates that are applicable to the yield, credit quality and maturity of each loan. Fair values of residential mortgage loans are determined by a pricing and servicing model using market rates that are applicable to the yield, rate structure, credit quality, size and maturity of each loan.

The fair values for assets classified as policy loans, other investments excluding equity investments in subsidiaries, cash and cash equivalents and accrued investment income in the accompanying consolidated statements of financial position approximate their carrying amounts.

Mortgage servicing rights represent the present value of estimated future net revenues from contractually specified servicing fees. The fair value was estimated with a valuation model using current prepayment speeds and a market discount rate.

The fair values of the Company's reserves and liabilities for investment-type insurance contracts (insurance, annuity and other policy contracts that do not involve significant mortality or morbidity risk and that are only a portion of the policyholder liabilities appearing in the consolidated statements of financial position) are estimated using discounted cash flow analyses (based on current interest rates being offered for similar contracts with maturities consistent with those remaining for the investment-type contracts being valued). The fair values for the Company's insurance contracts (insurance, annuity and other policy contracts that do involve significant mortality or morbidity risk), other than investment-type contracts, are not required to be disclosed. The Company does consider, however, the various insurance and investment risks in choosing investments for both insurance and investment-type contracts.

Fair values for debt issues are estimated using discounted cash flow analysis based on the Company's incremental borrowing rate for similar borrowing arrangements.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

13. FAIR VALUE OF FINANCIAL INSTRUMENTS -- (CONTINUED)

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2000 and 1999, are as follows (in millions):

	2000		1999	
	CARRYING AMOUNT	FAIR VALUE	CARRYING AMOUNT	FAIR VALUE
Assets (liabilities)				
Fixed maturities (see Note 3).....	\$ 26,839.9	\$ 26,839.9	\$ 23,443.9	\$ 23,443.9
Equity securities (see Note 3).....	742.9	742.9	864.2	864.2
Mortgage loans.....	11,492.7	11,741.9	13,332.2	13,200.0
Policy loans.....	803.6	803.6	780.5	780.5
Other investments.....	507.5	507.5	253.9	253.9
Cash and cash equivalents.....	926.6	926.6	569.5	569.5
Accrued investment income.....	530.8	530.8	472.0	472.0
Mortgage loan servicing rights.....	1,084.4	1,193.5	1,081.0	1,288.0
Investment-type insurance contracts.....	(22,818.6)	(22,688.9)	(24,072.5)	(23,322.6)
Short-term debt.....	(459.5)	(459.5)	(547.3)	(547.3)
Long-term debt.....	(1,336.5)	(1,343.1)	(1,492.9)	(1,441.4)

14. STATUTORY INSURANCE FINANCIAL INFORMATION

Principal Life, the largest subsidiary (indirect) of Principal Mutual Holding Company, prepares statutory financial statements in accordance with the accounting practices prescribed or permitted by the Insurance Division of the Department of Commerce of the State of Iowa. Currently "prescribed" statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners ("NAIC") as well as state laws, regulations and general administrative rules. "Permitted" statutory accounting practices encompass all accounting practices not so prescribed. The impact of any permitted accounting practices on statutory surplus is not material. The accounting practices used to prepare statutory financial statements for regulatory filings differ in certain instances from GAAP. Prescribed or permitted statutory accounting practices are used by state insurance departments to regulate the Company.

The NAIC revised the Accounting Practices and Procedures Manual in a process referred to as Codification. The revised manual will be effective January 1, 2001. The State of Iowa has adopted the provisions of the revised manual without modification. The revised manual has changed, to some extent, prescribed statutory accounting practices and will result in changes to the accounting practices that Principal Life uses to prepare its statutory-basis financial statements.

The Company has identified the following changes in prescribed statutory accounting practices as those that will have the most significant impact on Principal Life's statutory-basis financial statements:

- Deposit-type funds related to both Principal Life's general account and its separate accounts will no longer be reported in the statutory statement of operations as revenues, but rather will be reported directly to an appropriate policy reserve account, a treatment of deposit-type funds that is similar to that under GAAP. This will have the effect of decreasing total statutory revenues and total statutory expenses of Principal Life, with no effect to statutory net income or statutory surplus.
- Undistributed income from subsidiaries will no longer be reported as a component of statutory net investment income, but rather will be classified as statutory unrealized capital gains and losses. This will have the effect of decreasing Principal Life's total statutory revenues, with a related effect on statutory net income; however, it will have no effect on statutory surplus.
- Deferred income tax assets and/or liabilities will be recognized. This will have the effect of increasing Principal Life's total statutory assets or statutory liabilities to the extent it has such deferred income tax assets or liabilities and will have a corresponding effect on Principal Life's statutory surplus.

Management believes the net impact of these changes to Principal Life's statutory-basis capital and surplus as of January 1, 2001 will not be significant. Insurance regulators, accountants, and the insurance industry continue work to finalize interpretations of the Codification. The ongoing implementation work could cause changes to final interpretations that could ultimately have an adverse effect on Principal Life's statutory surplus or statutory net income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

14. STATUTORY INSURANCE FINANCIAL INFORMATION -- (CONTINUED)

Life/Health insurance companies are subject to certain risk-based capital ("RBC") requirements as specified by the NAIC. Under those requirements, the amount of capital and surplus maintained by a life/health insurance company is to be determined based on the various risk factors related to it. At December 31, 2000, Principal Life meets the RBC requirements.

Under Iowa law, Principal Life may pay stockholder dividends only from the earned surplus arising from its business and must receive the prior approval of the Insurance Commissioner of the State of Iowa to pay a stockholder dividend if such a stockholder dividend would exceed certain statutory limitations. The current statutory limitation is the greater of 10% of Principal Life's policyholder surplus as of the preceding year end or the net gain from operations from the previous calendar year. Based on this limitation and 2000 statutory results, Principal Life could pay approximately \$760.9 million in stockholder dividends in 2001 without exceeding the statutory limitation.

In 2000, Principal Life notified the Insurance Commissioner of the State of Iowa in advance of all stockholder dividend payments. Total stockholder dividends paid to its parent company in 2000 were \$538.8 million.

In 1999, Principal Life notified the Insurance Commissioner of the State of Iowa in advance of all stockholder dividend payments and received approval for an extraordinary stockholder dividend of \$250.0 million. Total stockholder dividends paid to its parent company in 1999 were \$509.0 million.

In 1998, Principal Life notified the Insurance Commissioner of the State of Iowa in advance of dividend payments. Total stockholder dividends paid to its parent company in 1998 were \$140.0 million.

The following summary reconciles the assets and equity at December 31, 2000, 1999 and 1998, and net income for the years ended December 31, 2000, 1999 and 1998, in accordance with statutory reporting practices prescribed or permitted by the Insurance Division of the Department of Commerce of the State of Iowa (Principal Life only) with that reported in these consolidated GAAP financial statements (in millions):

	ASSETS	EQUITY	NET INCOME
	-----	-----	-----
<b>DECEMBER 31, 2000</b>			
As reported in accordance with statutory accounting practices -- unconsolidated.....	\$75,573.4	\$3,356.4	\$ 912.6
Additions (deductions):			
Unrealized gain on fixed maturities available-for-sale....	375.3	375.3	--
Other investment adjustments.....	2,760.2	590.3	(137.7)
Adjustments to insurance reserves and policyholder dividends.....	74.0	(187.0)	26.3
Deferral of policy acquisition costs.....	1,295.5	1,295.5	8.8
Surplus note reclassification as debt.....	--	(298.0)	--
Provision for deferred federal income taxes and other tax reclassifications.....	--	(138.3)	(26.6)
Other -- net.....	324.5	306.0	(141.8)
	-----	-----	-----
As reported in accordance with GAAP --			
Principal Life only.....	80,402.9	5,300.2	641.6
Parent holding company totals.....	4,002.0	952.3	(21.4)
	-----	-----	-----
As reported in the consolidated GAAP financial statements...	\$84,404.9	\$6,252.5	\$ 620.2
	=====	=====	=====
<b>DECEMBER 31, 1999</b>			
As reported in accordance with statutory accounting practices -- unconsolidated.....	\$76,017.7	\$3,151.9	\$ 713.7
Additions (deductions):			
Unrealized loss on fixed maturities available-for-sale....	(356.8)	(356.8)	--
Other investment adjustments.....	2,093.3	994.4	9.8
Adjustments to insurance reserves and policyholder dividends.....	(3.6)	(235.5)	15.1
Deferral of policy acquisition costs.....	1,409.3	1,409.3	68.3
Surplus note reclassification as debt.....	--	(297.8)	--
Provision for deferred federal income taxes and other tax reclassifications.....	--	33.0	18.2
Other -- net.....	277.1	252.5	(15.4)
	-----	-----	-----
As reported in accordance with GAAP --			
Principal Life only.....	79,437.0	4,951.0	809.7
Parent holding company totals.....	4,516.2	601.9	(67.6)
	-----	-----	-----
As reported in the consolidated GAAP financial statements...	\$83,953.2	\$5,552.9	\$ 742.1
	=====	=====	=====

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

14. STATUTORY INSURANCE FINANCIAL INFORMATION -- (CONTINUED)

	ASSETS -----	EQUITY -----	NET INCOME -----
DECEMBER 31, 1998			
As reported in accordance with statutory accounting practices -- unconsolidated.....	\$70,096.1	\$3,031.5	\$ 511.4
Additions (deductions):			
Unrealized gain on fixed maturities available-for-sale....	996.9	996.9	--
Other investment adjustments.....	1,620.7	1,080.9	176.8
Adjustments to insurance reserves and policyholder dividends.....	(66.1)	(191.6)	(55.8)
Deferral of policy acquisition costs.....	1,104.7	1,104.7	--
Surplus note reclassification as debt.....	--	(297.8)	--
Provision for deferred federal income taxes and other tax reclassifications.....	--	(474.2)	164.9
Other -- net.....	294.4	219.0	(102.0)
	-----	-----	-----
As reported in accordance with GAAP --			
Principal Life only.....	74,046.7	5,469.4	695.3
Parent holding company totals.....	--	197.8	(2.3)
	-----	-----	-----
As reported in the consolidated GAAP financial statements...	\$74,046.7	\$5,667.2	\$ 693.0
	=====	=====	=====

15. SEGMENT INFORMATION

The Company provides financial products and services through the following segments: U.S. Asset Management and Accumulation, International Asset Management and Accumulation, Life and Health Insurance and Mortgage Banking. In addition, there is a Corporate and Other segment. The segments are managed and reported separately because they provide different products and services, have different strategies or have different markets and distribution channels.

The U.S. Asset Management and Accumulation segment provides retirement and related financial products and services primarily to businesses, their employees and other individuals and provides asset management services to the Company's asset accumulation business, the life and health insurance operations and third-party clients.

The International Asset Management and Accumulation segment provides asset management products and services to retail clients in Australia and institutional clients throughout the world and provides life insurance and retirement and related financial products and services primarily to businesses, their employees and other individuals principally in Australia, Chile, Brazil, New Zealand, Mexico, India, Japan, Argentina, and Hong Kong.

The Life and Health insurance segment provides individual life and disability insurance to the owners and employees of businesses and other individuals in the United States and provides group life and health insurance to businesses in the United States.

The Mortgage Banking segment originates and services residential mortgage loan products for customers primarily in the United States.

The Corporate and Other segment manages the assets representing capital that has not been allocated to any other segment. Financial results of the Corporate and Other segment primarily reflect financing activities for the Company, income on capital not allocated to other segments, intercompany eliminations, and non-recurring or other income or expenses not allocated to the segments based on review of the nature of such items.

The Company evaluates segment performance on segment operating earnings, which excludes the effect of net realized capital gains and losses, as adjusted, and non-recurring events and transactions. Net realized capital gains, as adjusted, are net of tax, related changes in the amortization pattern of deferred policy acquisition costs, recognition of front-end fee revenues for sales charges on pension products and services and net realized capital gains credited to customers. Segment operating revenues exclude net realized capital gains and their impact on recognition of front-end fee revenues. Segment operating earnings is determined by adjusting GAAP net income for net realized capital gains and losses and non-recurring items which management believes are not indicative of overall operating trends. While these items may be significant components in understanding and assessing the consolidated financial performance, management believes the presentation of segment operating earnings enhances the understanding of the Company's results of operations by highlighting earnings attributable to the normal, recurring operations of the business. However, segment operating earnings are not a substitute for net income determined in accordance with GAAP.

In 2000, the Company excluded \$101.0 million of non-recurring items, net of tax, from net income for the presentation of operating earnings. The non-recurring items included the negative effects of (a) a loss contingency

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

15. SEGMENT INFORMATION -- (CONTINUED)

reserve established for sales practices litigation (\$93.8 million) and (b) expenses related to the development of a plan of demutualization (\$7.2 million).

In 1998, the Company excluded \$104.8 million of non-recurring items, net of tax, from net income for the presentation of operating earnings. The non-recurring items included: (1) the positive effects of (a) Principal Life's release of tax reserves and related accrued interest (\$164.4 million) and (b) accounting changes by the Company's international operations (\$13.3 million) and (2) the negative effects of (a) expenses related to the Company's corporate structure change to a mutual insurance holding company and related adjustments for changes in amortization assumptions for deferred policy acquisition costs (\$27.4 million) and (b) a contribution related to permanent endowment of the Principal Financial Group Foundation (\$45.5 million).

The accounting policies of the segments are similar to those as described in Note 1, with the exception of capital allocation. The Company allocates capital to its segments based upon an internal capital model that allows management to more effectively manage the Company's capital.

The following table summarizes selected financial information by segment as of, or for the year ended, December 31 and reconciles segment totals to those reported in the consolidated financial statements (in millions):

	U.S. ASSET MANAGEMENT AND ACCUMULATION	INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION	LIFE AND HEALTH INSURANCE	MORTGAGE BANKING	CORPORATE AND OTHER	CONSOLIDATED
<b>2000</b>						
Revenues						
Operating revenues.....	\$ 3,533.9	\$ 630.7	\$ 4,122.6	\$ 359.8	\$ 97.1	\$ 8,744.1
Net realized capital gains (losses)....	(53.8)	2.8	70.8	--	120.1	139.9
Plus (less) recognition of front-end fee revenues.....	0.9	--	--	--	--	0.9
	-----	-----	-----	-----	-----	-----
Revenues.....	\$ 3,481.0	\$ 633.5	\$ 4,193.4	\$ 359.8	\$ 217.2	\$ 8,884.9
	=====	=====	=====	=====	=====	=====
Net income:						
Operating earnings (loss).....	\$ 356.6	\$ (8.5)	\$ 162.3	\$ 50.0	\$ 67.7	\$ 628.1
Net realized capital gains (losses), as adjusted.....	(35.9)	1.4	47.3	--	80.3	93.1
Non-recurring items.....	--	--	--	--	(101.0)	(101.0)
	-----	-----	-----	-----	-----	-----
Net income (loss).....	\$ 320.7	\$ (7.1)	\$ 209.6	\$ 50.0	\$ 47.0	\$ 620.2
	=====	=====	=====	=====	=====	=====
Assets.....	\$65,795.9	\$5,525.9	\$10,569.0	\$1,556.3	\$ 957.8	\$84,404.9
	=====	=====	=====	=====	=====	=====
Other segment data:						
Revenues from external customers.....	\$ 3,399.1	\$ 632.4	\$ 4,196.9	\$ 359.8	\$ 296.7	\$ 8,884.9
Intersegment revenues.....	81.9	1.1	(3.5)	--	(79.5)	--
Interest expense.....	--	--	--	--	78.4	78.4
Income tax expense (benefit).....	102.0	6.1	104.7	27.0	0.5	240.3
Amortization of goodwill and other intangibles.....	1.0	47.9	7.7	0.8	(1.1)	56.3
<b>1999</b>						
Revenues:						
Operating revenues.....	\$ 3,472.6	\$ 379.6	\$ 3,985.5	\$ 398.3	\$ 61.9	\$ 8,297.9
Net realized capital gains (losses)....	(58.0)	8.7	16.0	--	437.8	404.5
Plus (less) recognition of front-end fee revenues.....	(1.0)	--	--	--	--	(1.0)
	-----	-----	-----	-----	-----	-----
Revenues.....	\$ 3,413.6	\$ 388.3	\$ 4,001.5	\$ 398.3	\$ 499.7	\$ 8,701.4
	=====	=====	=====	=====	=====	=====

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

15. SEGMENT INFORMATION -- (CONTINUED)

	U.S. ASSET MANAGEMENT AND ACCUMULATION	INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION	LIFE AND HEALTH INSURANCE	MORTGAGE BANKING	CORPORATE AND OTHER	CONSOLIDATED
	-----	-----	-----	-----	-----	-----
1999 (CONTINUED)						
Net income:						
Operating earnings (loss).....	\$ 356.6	\$ (38.4)	\$ 90.7	\$ 56.8	\$ 9.5	\$ 475.2
Net realized capital gains (losses), as adjusted.....	(35.4)	7.7	10.1	--	284.5	266.9
Non-recurring items.....	--	--	--	--	--	--
Net income (loss).....	<u>\$ 321.2</u>	<u>\$ (30.7)</u>	<u>\$ 100.8</u>	<u>\$ 56.8</u>	<u>\$ 294.0</u>	<u>\$ 742.1</u>
Assets.....	<u>\$65,096.4</u>	<u>\$5,926.8</u>	<u>\$10,070.8</u>	<u>\$1,737.7</u>	<u>\$1,121.5</u>	<u>\$83,953.2</u>
Other segment data:						
Revenues from external customers.....	\$ 3,338.7	\$ 388.3	\$ 4,007.9	\$ 398.3	\$ 568.2	\$ 8,701.4
Intersegment revenues.....	74.9	--	(6.4)	--	(68.5)	--
Interest expense.....	--	0.7	--	--	47.1	47.8
Income tax expense (benefit).....	126.4	(3.2)	18.1	30.7	151.5	323.5
Amortization of goodwill and other intangibles.....	1.0	16.0	4.0	0.8	(1.6)	20.2
1998						
Revenues:						
Operating revenues.....	\$ 2,933.1	\$ 223.1	\$ 3,893.1	\$ 340.6	\$ 342.5	\$ 7,732.4
Net realized capital gains (losses)....	48.8	13.5	(1.3)	--	404.8	465.8
Plus (less) recognition of front-end fee revenues.....	(1.3)	--	--	--	--	(1.3)
Revenues.....	<u>\$ 2,980.6</u>	<u>\$ 236.6</u>	<u>\$ 3,891.8</u>	<u>\$ 340.6</u>	<u>\$ 747.3</u>	<u>\$ 8,196.9</u>
Net income:						
Operating earnings (loss).....	\$ 238.4	\$ (35.4)	\$ 50.0	\$ 58.8	\$ (44.3)	\$ 267.5
Net realized capital gains (losses), as adjusted.....	14.7	12.0	1.9	--	292.1	320.7
Non-recurring items.....	23.9	13.3	60.1	--	7.5	104.8
Net income (loss).....	<u>\$ 277.0</u>	<u>\$ (10.1)</u>	<u>\$ 112.0</u>	<u>\$ 58.8</u>	<u>\$ 255.3</u>	<u>\$ 693.0</u>
Assets.....	<u>\$58,701.5</u>	<u>\$1,239.4</u>	<u>\$ 9,219.5</u>	<u>\$1,810.4</u>	<u>\$3,075.9</u>	<u>\$74,046.7</u>
Other segment data:						
Revenues from external customers.....	\$ 2,980.6	\$ 236.6	\$ 3,891.8	\$ 340.6	\$ 747.3	\$ 8,196.9
Intersegment revenues.....	--	--	--	--	--	--
Interest expense.....	--	--	--	--	27.4	27.4
Income tax expense (benefit).....	78.7	(10.5)	(26.6)	31.6	(31.0)	42.2
Amortization of goodwill and other intangibles.....	18.1	6.9	18.1	4.0	5.5	52.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

15. SEGMENT INFORMATION -- (CONTINUED)

The Company operates in the United States and in selected markets internationally (including Australia, Chile, Brazil, New Zealand, Mexico, India, Japan, Argentina, Spain and Hong Kong). The following table summarizes selected financial information by geographic location as of or for the year ended December 31 (in millions):

	REVENUES	LONG-LIVED ASSETS	ASSETS	NET INCOME (LOSS)
	-----	-----	-----	-----
<b>2000</b>				
United States.....	\$8,251.4	\$ 517.7	\$78,879.0	\$627.3
International.....	633.5	1,365.2	5,525.9	(7.1)
	-----	-----	-----	-----
Total.....	\$8,884.9	\$1,882.9	\$84,404.9	\$620.2
	=====	=====	=====	=====
<b>1999</b>				
United States.....	\$8,313.1	\$ 505.0	\$78,026.4	\$772.8
International.....	388.3	1,474.2	5,926.8	(30.7)
	-----	-----	-----	-----
Total.....	\$8,701.4	\$1,979.2	\$83,953.2	\$742.1
	=====	=====	=====	=====
<b>1998</b>				
United States.....	\$7,960.3	\$ 493.6	\$72,807.3	\$703.1
International.....	236.6	116.9	1,239.4	(10.1)
	-----	-----	-----	-----
Total.....	\$8,196.9	\$ 610.5	\$74,046.7	\$693.0
	=====	=====	=====	=====

Long-lived assets include property and equipment and goodwill and other intangibles.

The Corporate and Other segment includes an equity ownership interest in Coventry Health Care, Inc. The ownership interest was initiated through a transaction in 1998, described further in Note 2. In September 2000, the Company sold a portion of its equity ownership position, which reduced its ownership to approximately 25% and resulted in a realized capital gain of \$13.9 million, net of tax. The Corporate and Other segment's equity in earnings of Coventry Health Care, Inc., which was included in net investment income, was \$20.0 million and \$19.1 million for the years ended December 31, 2000 and 1999, respectively. The investment in Coventry Health Care, Inc. was \$122.9 million and \$179.3 million at December 31, 2000 and 1999, respectively. The Corporate and Other segment also include consolidating and intersegment eliminations.

The Company's operations are not materially dependent on one or a few customers, brokers or agents, and revenues, assets and operating earnings are attributed to geographic location based on the country of domicile sales originate from.

16. SUBSEQUENT EVENTS

PLAN OF DEMUTUALIZATION AND INITIAL PUBLIC OFFERING

On March 31, 2001, the Company's Board of Directors adopted a plan to convert Principal Mutual Holding Company from a mutual insurance holding company to a stock company. Adoption of the plan authorized management to implement the plan for demutualization of the Company. Upon demutualization, the membership interests of Principal Life's policyholders in Principal Mutual Holding Company will be extinguished, and eligible policyholders will receive compensation in exchange for the extinguishment of their membership interests. Their compensation will be in the form of common stock, cash or policy credits, depending upon the type of policy or policyholder.

Under Iowa insurance law, the plan also requires the approval of policyholders and the Insurance Commissioner of the State of Iowa. During June 2001, policyholders received the plan of conversion and Principal Financial Group, Inc. filed a registration statement with the Securities and Exchange Commission relating to a proposed initial public offering of common stock. The registration statement is expected to become effective in the latter part of 2001 or first part of 2002, when shares are expected to be sold to the public.

On July 24, 2001, Principal Life's policyholders approved the plan for demutualization. The plan was submitted to the Insurance Commissioner of the State of Iowa for approval and a public hearing was held on July 25, 2001. The Insurance Commissioner of the State of Iowa approved the plan of conversion on August 28, 2001.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 16. SUBSEQUENT EVENTS -- (CONTINUED)

## LITIGATION

In April 2001, the proposed settlement of the class-action lawsuit alleging improper sales practices received court approval. In agreeing to the settlement, the Company specifically denied any wrongdoing. The Company has accrued a loss reserve for its best estimate based on information available. As uncertainties continue to exist in resolving this matter, it is reasonably possible that, as the actual cost of the claims subject to alternative dispute resolution becomes available, the final cost of settlement could exceed the Company's estimate. The range of any additional cost related to the settlement cannot be presently estimated, however the Company believes the settlement will not have a material impact on its business, financial condition or results of operations. A number of persons and entities who were eligible to be class members have excluded themselves from the class (or "opted out"), as the law permits them to do. The Company has been notified that some of those who opted out from the class will file lawsuits and make claims similar to those addressed by the settlement.

## TERRORIST ATTACKS IN THE UNITED STATES

On September 11, 2001, terrorist attacks in the United States resulted in significant loss of life and property, as well as interruption of business activities and an overall disruption of the world economy. Management estimates that the Company's losses from insurance claims from these events, primarily individual life insurance claims, to be between \$9.0 million and \$12.0 million after taxes, taking into consideration reinsurance coverage. Management has estimated no material property or investment real estate loss exposures resulting from these events. However, the continuing impacts of these events on the world economy and financial markets cannot presently be determined. This creates related uncertainties as to the future realization of and return on certain invested assets; the impact on the Company's assumptions in assessing the value of intangibles from prior acquisitions and the amortization patterns for deferred policy acquisition costs; and the impact on future operating results, for which estimates cannot presently be made.

PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

FOR THE SIX  
MONTHS ENDED  
JUNE 30,

-----  
2001            2000  
-----

(IN MILLIONS)

REVENUES		
Premiums and other considerations.....	\$1,955.3	\$1,992.7
Fees and other revenues.....	856.3	783.2
Net investment income.....	1,686.0	1,558.1
Net realized capital gains (losses).....	(176.9)	31.5
	-----	-----
Total revenues.....	4,320.7	4,365.5
EXPENSES		
Benefits, claims and settlement expenses.....	2,639.2	2,631.1
Dividends to policyholders.....	162.1	155.8
Operating expenses.....	1,228.2	1,228.0
	-----	-----
Total expenses.....	4,029.5	4,014.9
	-----	-----
Income before income taxes and cumulative effect of accounting change.....	291.2	350.6
Income taxes.....	56.1	105.3
	-----	-----
Income before cumulative effect of accounting change.....	235.1	245.3
Cumulative effect of accounting change, net of related income taxes.....	(10.7)	--
	-----	-----
Net income.....	\$ 224.4	\$ 245.3
	=====	=====

See accompanying notes.

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PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION  
(UNAUDITED)

	JUNE 30, 2001	DECEMBER 31, 2000
	-----	-----
	(IN MILLIONS)	
<b>ASSETS</b>		
Fixed maturities, available-for-sale.....	\$29,328.2	\$26,839.9
Equity securities, available-for-sale.....	578.8	742.9
Mortgage loans.....	11,539.1	11,492.7
Real estate.....	1,238.3	1,400.5
Policy loans.....	820.1	803.6
Other investments.....	898.7	811.0
	-----	-----
Total investments.....	44,403.2	42,090.6
Cash and cash equivalents.....	371.9	926.6
Accrued investment income.....	577.9	530.8
Premiums due and other receivables.....	572.3	505.7
Deferred policy acquisition costs.....	1,338.3	1,333.3
Property and equipment.....	513.4	507.0
Goodwill and other intangibles.....	1,252.9	1,375.9
Mortgage loan servicing rights.....	1,487.2	1,084.4
Separate account assets.....	33,739.5	34,916.2
Other assets.....	973.1	1,134.4
	-----	-----
Total assets.....	\$85,229.7	\$84,404.9
	=====	=====
<b>LIABILITIES</b>		
Contractholder funds.....	\$25,073.1	\$24,300.2
Future policy benefits and claims.....	13,494.8	13,346.0
Other policyholder funds.....	591.5	597.4
Short-term debt.....	675.9	459.5
Long-term debt.....	1,390.6	1,336.5
Income taxes currently payable.....	3.6	108.4
Deferred income taxes.....	740.1	487.4
Separate account liabilities.....	33,739.5	34,916.2
Other liabilities.....	2,992.2	2,600.8
	-----	-----
Total liabilities.....	78,701.3	78,152.4
<b>EQUITY</b>		
Retained earnings.....	6,536.9	6,312.5
Accumulated other comprehensive income (loss):		
Net unrealized gains on available-for-sale securities.....	268.6	129.9
Net foreign currency translation adjustment.....	(277.1)	(189.9)
	-----	-----
Total equity.....	6,528.4	6,252.5
	-----	-----
Total liabilities and equity.....	\$85,229.7	\$84,404.9
	=====	=====

See accompanying notes.  
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PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF EQUITY  
(UNAUDITED)

	RETAINED EARNINGS	NET UNREALIZED GAINS (LOSSES) ON AVAILABLE-FOR- SALE SECURITIES	NET FOREIGN CURRENCY TRANSLATION ADJUSTMENT	TOTAL EQUITY
	-----	-----	-----	-----
	(IN MILLIONS)			
BALANCES AT JANUARY 1, 2000.....	\$5,692.3	\$ (79.1)	\$ (60.3)	\$5,552.9
Comprehensive income:				
Net income.....	245.3	--	--	245.3
Net change in unrealized gains and losses on fixed maturities, available-for-sale.....	--	56.2	--	56.2
Net change in unrealized gains and losses on equity securities, available-for-sale, including seed money in separate accounts.....	--	(187.7)	--	(187.7)
Adjustments for assumed changes in amortization patterns:				
Deferred policy acquisition costs.....	--	(10.9)	--	(10.9)
Unearned revenue reserves.....	--	5.2	--	5.2
Provision for deferred income tax benefit.....	--	38.1	--	38.1
Change in net foreign currency translation adjustment.....	--	--	(65.3)	(65.3)
Comprehensive income.....				80.9
BALANCES AT JUNE 30, 2000.....	\$5,937.6	\$(178.2)	\$(125.6)	\$5,633.8
BALANCES AT JANUARY 1, 2001.....	\$6,312.5	\$ 129.9	\$(189.9)	\$6,252.5
Comprehensive income:				
Net income.....	224.4	--	--	224.4
Net change in unrealized gains and losses on fixed maturities, available-for-sale.....	--	181.4	--	181.4
Net change in unrealized gains and losses on equity securities, available-for-sale, including seed money in separate accounts.....	--	72.2	--	72.2
Adjustments for assumed changes in amortization patterns:				
Deferred policy acquisition costs.....	--	(26.8)	--	(26.8)
Unearned revenue reserves.....	--	0.6	--	0.6
Provision for deferred income taxes.....	--	(85.6)	--	(85.6)
Change in net foreign currency translation adjustment.....	--	--	(76.1)	(76.1)
Cumulative effect of accounting change, net of related income taxes.....	--	(3.1)	(11.1)	(14.2)
Comprehensive income.....				275.9
BALANCES AT JUNE 30, 2001.....	\$6,536.9	\$ 268.6	\$(277.1)	\$6,528.4

See accompanying notes.  
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PRINCIPAL MUTUAL HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

FOR THE SIX MONTHS  
ENDED JUNE 30,  
-----  
2001                      2000  
-----  
(IN MILLIONS)

OPERATING ACTIVITIES		
Net income.....	\$ 224.4	\$ 245.3
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of accounting change, net of related income taxes.....	10.7	--
Amortization of deferred policy acquisition costs.....	104.3	90.3
Additions to deferred policy acquisition costs.....	(133.5)	(128.3)
Accrued investment income.....	(49.6)	2.5
Premiums due and other receivables.....	(10.0)	58.0
Contractholder and policyholder liabilities and dividends.....	421.0	600.5
Current and deferred income taxes.....	41.7	(42.2)
Net realized capital (gains) losses.....	176.9	(31.5)
Depreciation and amortization expense.....	74.3	74.2
Amortization and impairment/recovery of mortgage servicing rights.....	128.7	78.4
Other.....	463.3	(131.9)
	-----	-----
Net cash provided by operating activities.....	1,452.2	815.3
INVESTING ACTIVITIES		
Available-for-sale securities:		
Purchases.....	(7,041.0)	(5,699.0)
Sales.....	3,035.1	4,650.0
Maturities.....	1,404.2	1,316.6
Mortgage loans acquired or originated.....	(16,789.4)	(4,301.2)
Mortgage loans sold or repaid.....	16,778.4	4,366.0
Net change in mortgage servicing rights.....	(366.3)	(39.6)
Real estate acquired.....	(180.4)	(181.1)
Real estate sold.....	394.4	212.3
Net change in property and equipment.....	(42.0)	(10.1)
Net proceeds from sales of subsidiaries.....	(13.5)	--
Purchases of interest in subsidiaries, net of cash acquired.....	(4.2)	(25.7)
Net change in other investments.....	(134.9)	21.8
	-----	-----
Net cash provided by (used in) investing activities.....	(2,959.6)	310.0
FINANCING ACTIVITIES		
Issuance of debt.....	146.4	49.8
Principal repayments of debt.....	(92.3)	(10.5)
Proceeds of short-term borrowings.....	4,276.5	1,213.3
Repayment of short-term borrowings.....	(4,060.1)	(1,369.9)
Investment contract deposits.....	3,149.4	1,630.1
Investment contract withdrawals.....	(2,467.2)	(2,621.9)
	-----	-----
Net cash provided by (used in) financing activities.....	952.7	(1,109.1)
	-----	-----
Net increase (decrease) in cash and cash equivalents.....	(554.7)	16.2
Cash and cash equivalents at beginning of period.....	926.6	569.5
	-----	-----
Cash and cash equivalents at end of period.....	\$ 371.9	\$ 585.7
	=====	=====

See accompanying notes.  
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PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2001

(UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying consolidated financial statements of Principal Mutual Holding Company and its consolidated subsidiaries ("the Company") have been prepared in accordance with generally accepted accounting principles for interim financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six month period ended June 30, 2001 are not necessarily indicative of the results that may be expected for the year ended December 31, 2001. These interim financial statements should be read in conjunction with the Company's annual financial statements as of December 31, 2000. The accompanying consolidated statement of financial position at December 31, 2000 has been derived from the audited consolidated statement of financial position.

Reclassifications have been made to the December 31, 2000, and June 30, 2000, financial statements to conform to the June 30, 2001, presentation.

2. ACCOUNTING CHANGES

In June 1998, the Financial Accounting Standards Board (the "FASB") issued Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133"). In June 1999, Statement No. 137, Accounting for Derivative Instruments and Hedging Activities -- Deferral of the Effective Date of FASB Statement No. 133 was issued deferring the effective date of SFAS 133 by one year. In June 2000, the FASB issued Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities -- an amendment of FASB Statement No. 133, which amended the accounting and reporting standards of SFAS 133 for certain derivative instruments and certain hedging activities.

The Company's derivatives are generally held for purposes other than trading and are primarily used to hedge or reduce exposure to interest rate and foreign currency risks associated with assets held or expected to be purchased or sold, and liabilities incurred or expected to be incurred. Additionally, derivatives are used to change the characteristics of the Company's asset/liability mix consistent with the Company's risk management activities.

The Company's risk of loss is typically limited to the fair value of its derivative instruments and not to the notional or contractual amounts of these derivatives. Risk arises from changes in the fair value of the underlying instruments. The Company is also exposed to credit losses in the event of nonperformance of the counterparties. This credit risk is minimized by purchasing such agreements from financial institutions with high credit ratings and by establishing and monitoring exposure limits.

The fair value of derivative instruments classified as assets at June 30, 2001, was \$200.5 million. Of this amount, the fair value of derivatives related to investment hedges was \$116.4 million and was reported with other invested assets on the consolidated statement of financial position. The fair value of derivatives related to residential mortgage loan servicing rights and residential mortgage loans was \$84.1 million and was reported with other assets on the consolidated statement of financial position. The fair value of derivative instruments classified as liabilities at June 30, 2001, was \$549.8 million and was reported with other liabilities on the consolidated statement of financial position.

The net interest effect of interest rate and currency swap transactions is recorded as an adjustment to net investment income or interest expense, as appropriate, over the periods covered by the agreements. The cost of other derivative contracts is amortized over the life of the contracts and classified with the results of the underlying hedged item. Futures contracts and mortgage-backed forwards are used to hedge anticipated transactions. Futures contracts are marked to market value and settled daily. However, changes in the market value of such contracts have not qualified for inclusion in the measurement of subsequent transactions or represent hedges of items reported at fair value. Accordingly, such changes in market value are reported in net income in the period of change.

Hedge accounting is used for derivatives that are specifically designated in advance as hedges and that reduce the Company's exposure to an indicated risk by having a high correlation between changes in the value of the derivatives and the items being hedged at both the inception of the hedge and throughout the hedge period. Should such criteria not be met or if the hedged items are sold, terminated or matured, the changes in value of the derivatives are included in net income.

The Company designates derivatives, identified as hedges into two types: hedges of fair value exposure and hedges of cash flow exposure. Hedges of fair value exposure are entered into in order to hedge the fair value of a recognized asset or liability. Hedges of cash flow exposure are entered into to hedge the variability of cash flows to be received or paid related to certain assets or liabilities. On the date the derivative contract is entered, the Company designates the contract as either a fair value or cash flow hedge. Changes in fair values of derivatives designated as effective and that qualify as fair value hedges are recognized in earnings as offsets to the changes in fair value of the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

2. ACCOUNTING CHANGES -- (CONTINUED)

hedged assets and liabilities. Changes in fair values of derivatives designated as effective and that qualify as cash flow hedges are deferred and recognized as a component of accumulated other comprehensive income until the hedged transaction occurs and are then recognized in earnings. Any ineffective portion of hedging a derivative contract's change in fair value is recognized in earnings. In certain cases, zero hedge ineffectiveness for cash flow hedges is assumed because the derivative instrument was constructed such that all terms of the derivative exactly match the hedged risk in the hedged item.

For the six months ended June 30, 2001, the Company recognized a pre-tax net gain of \$43.1 million related to the ineffective portion of its fair value hedges. The net gain includes a net gain of \$48.6 million related to hedges of residential mortgage loan servicing rights and was reported with other expenses on the consolidated statement of operations. The net gain also includes a net loss of \$5.5 million related to investment hedges and was reported with net realized capital gains on the consolidated statement of operations.

For the six months ended June 30, 2001, the Company recognized a \$22.8 million after-tax decrease in value related to cash flow hedges in accumulated other comprehensive income.

At January 1, 2001, the Company's consolidated financial statements were adjusted to record a cumulative effect of adopting SFAS 133, as follows (in millions):

	NET INCOME	ACCUMULATED OTHER COMPREHENSIVE INCOME
	-----	-----
Adjustment to fair value of derivative contracts(1).....	\$(16.4)	\$(15.8)
Income tax impact.....	5.7	1.6
	-----	-----
Total.....	\$(10.7)	\$(14.2)
	=====	=====

-----

(1) Amount presented is net of adjustment to hedged item.

Derivatives not designated as hedges primarily consist of swaptions and derivatives used to manage the interest rate risk on the Company's residential mortgage loan pipeline. Occasionally, the Company will sell a callable investment-type contract and may use interest rate swaptions or similar instruments to transform the callable liability into a fixed term liability. The Company manages interest rate risk on its residential mortgage loan pipeline by buying and selling mortgage-backed securities in the forward markets, over-the-counter options on mortgage-backed securities, U.S. Treasury futures contracts, and options on Treasury futures contracts. Although swaptions and other derivatives not designated as hedges are effective hedges from an economic standpoint, the Company does not elect hedge accounting treatment under SFAS 133.

3. SEGMENT INFORMATION

The Company provides financial products and services through the following segments: U.S. Asset Management and Accumulation, International Asset Management and Accumulation, Life and Health Insurance and Mortgage Banking. In addition, there is a Corporate and Other segment. The segments are managed and reported separately because they provide different products and services, have different strategies or have different markets and distribution channels.

The U.S. Asset Management and Accumulation segment provides retirement and related financial products and services primarily to businesses, their employees and other individuals and provides asset management services to the Company's asset accumulation business, the life and health insurance operations and third-party clients.

The International Asset Management and Accumulation segment provides asset management products and services to retail clients in Australia and institutional clients throughout the world and provides life insurance and retirement and related financial products and services primarily to businesses, their employees and other individuals principally in Australia, Chile, Brazil, New Zealand, Mexico, India, Japan, Argentina and Hong Kong.

The Life and Health Insurance segment provides individual life and disability insurance to the owners and employees of businesses and other individuals in the United States and provides group life and health insurance to businesses in the United States.

The Mortgage Banking segment originates and services residential mortgage loan products for customers primarily in the United States.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

3. SEGMENT INFORMATION -- (CONTINUED)

The Corporate and Other segment manages the assets representing capital that has not been allocated to any other segment. Financial results of the Corporate and Other segment primarily reflect financing activities for the Company, income on capital not allocated to other segments, intercompany eliminations, and non-recurring or other income or expenses not allocated to the segments based on review of the nature of such items.

The Company evaluates segment performance on segment operating earnings, which excludes the effect of net realized capital gains and losses, as adjusted, and non-recurring events and transactions. Net realized capital gains, as adjusted, are net of tax, related changes in the amortization pattern of deferred policy acquisition costs, recognition of front-end fee revenues for sales charges on pension products and services and net realized capital gains credited to customers. Segment operating revenues exclude net realized capital gains and their impact on recognition of front-end fee revenues. Segment operating earnings is determined by adjusting GAAP net income for net realized capital gains and losses and non-recurring items which management believes are not indicative of overall operating trends. While these items may be significant components in understanding and assessing the consolidated financial performance, management believes the presentation of segment operating earnings enhances the understanding of the Company's results of operations by highlighting earnings attributable to the normal, recurring operations of the business. However, segment operating earnings are not a substitute for net income determined in accordance with GAAP.

For the six months ended June 30, 2001, the Company excluded \$31.4 million of non-recurring items, net of tax, from net income for the presentation of operating earnings. The non-recurring items included the negative effects of: (a) expenses related to our demutualization (\$14.8 million); (b) a cumulative effect of change in accounting principle related to our implementation of SFAS 133 (\$10.7 million); and (c) a loss contingency reserve established for sales practices litigation (\$5.9 million).

For the six months ended June 30, 2000, the Company excluded \$75.8 million of non-recurring items, net of tax, from net income for the presentation of operating earnings. The non-recurring items included the negative effects of: (a) a loss contingency reserve established for sales practices litigation (\$75.0 million), and (b) expenses related to our demutualization (\$0.8 million).

The accounting policies of the segments are similar to those of the Company, with the exception of capital allocation. The Company allocates capital to its segments based upon an internal capital model that allows management to more effectively manage the Company's capital.

The following table summarizes selected financial information by segment as of, or for the six months ended, June 30 and reconciles segment totals to those reported in the consolidated financial statements (in millions):

	U.S. ASSET MANAGEMENT AND ACCUMULATION	INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION	LIFE AND HEALTH INSURANCE	MORTGAGE BANKING	CORPORATE AND OTHER	CONSOLIDATED
	-----	-----	-----	-----	-----	-----
2001						
Revenues:						
Operating revenues.....	\$ 1,858.2	\$ 310.1	\$ 1,978.2	\$ 293.1	\$ 57.5	\$ 4,497.1
Net realized capital losses, including recognition of front-end fee revenues.....	(64.9)	(38.7)	(9.1)	--	(63.7)	(176.4)
Revenues.....	\$ 1,793.3	\$ 271.4	\$ 1,969.1	\$ 293.1	\$ (6.2)	\$ 4,320.7
Net income:						
Operating earnings (loss).....	\$ 176.9	\$ (4.7)	\$ 90.9	\$ 68.8	\$ 32.1	\$ 364.0
Net realized capital losses, as adjusted.....	(40.8)	(21.2)	(4.7)	--	(41.5)	(108.2)
Non-recurring items.....	(10.8)	--	0.1	--	(20.7)	(31.4)
Net income (loss).....	\$ 125.3	\$ (25.9)	\$ 86.3	\$ 68.8	\$ (30.1)	\$ 224.4
Assets.....	\$66,182.4	\$4,919.6	\$10,637.2	\$2,168.9	\$1,321.6	\$85,229.7

PRINCIPAL MUTUAL HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

3. SEGMENT INFORMATION -- (CONTINUED)

	U.S. ASSET MANAGEMENT AND ACCUMULATION	INTERNATIONAL ASSET MANAGEMENT AND ACCUMULATION	LIFE AND HEALTH INSURANCE	MORTGAGE BANKING	CORPORATE AND OTHER	CONSOLIDATED
2001 (CONTINUED)						
Other segment data:						
Revenues from external customers.....	\$ 1,744.5	\$ 270.8	\$ 1,970.8	\$ 293.1	\$ 41.5	\$ 4,320.7
Intersegment revenues.....	48.8	0.6	(1.7)	--	(47.7)	--
Interest expense.....	2.1	0.1	2.2	--	36.1	40.5
Income tax expense (benefit).....	16.8	(19.8)	43.5	37.0	(21.4)	56.1
Amortization of goodwill and other intangibles.....	0.5	26.2	2.0	0.4	(0.5)	28.6
2000						
Revenues:						
Operating revenues.....	\$ 1,700.7	\$ 309.5	\$ 2,100.7	\$ 180.7	\$ 40.5	\$ 4,332.1
Net realized capital gains (losses), including recognition of front-end fee revenues.....	(49.5)	3.7	76.0	--	3.2	33.4
Revenues.....	\$ 1,651.2	\$ 313.2	\$ 2,176.7	\$ 180.7	\$ 43.7	\$ 4,365.5
Net income:						
Operating earnings (loss).....	\$ 177.3	\$ (3.7)	\$ 86.0	\$ 34.4	\$ 4.0	\$ 298.0
Net realized capital gains (losses), as adjusted.....	(35.1)	3.5	50.1	--	4.6	23.1
Non-recurring items.....	--	--	--	--	(75.8)	(75.8)
Net income.....	\$ 142.2	\$ (0.2)	\$ 136.1	\$ 34.4	\$ (67.2)	\$ 245.3
Assets.....	\$65,109.4	\$5,547.3	\$10,293.8	\$1,606.3	\$1,789.5	\$84,346.3
Other segment data:						
Revenues from external customers.....	\$ 1,615.7	\$ 312.5	\$ 2,178.3	\$ 180.7	\$ 78.3	\$ 4,365.5
Intersegment revenues.....	35.5	0.7	(1.6)	--	(34.6)	--
Interest expense.....	5.1	0.1	1.3	--	42.3	48.8
Income tax expense (benefit).....	52.3	2.4	67.0	18.6	(35.0)	105.3
Amortization of goodwill and other intangibles.....	0.5	23.9	2.1	0.4	(0.6)	26.3

The Company operates in the United States and in selected markets internationally (including Australia, Chile, Brazil, New Zealand, Mexico, India, Japan, Argentina and Hong Kong). The following table summarizes selected financial information by geographic location as of or for the six months ended June 30 (in millions):

	REVENUES	LONG-LIVED ASSETS	ASSETS	NET INCOME (LOSS)
2001				
United States.....	\$4,049.3	\$ 547.9	\$80,310.1	\$250.3
International.....	271.4	1,218.4	4,919.6	(25.9)
Total.....	\$4,320.7	\$1,766.3	\$85,229.7	\$224.4
2000				
United States.....	\$4,052.3	\$ 495.3	\$78,799.0	\$245.5
International.....	313.2	1,451.8	5,547.3	(0.2)
Total.....	\$4,365.5	\$1,947.1	\$84,346.3	\$245.3

Long-lived assets include property and equipment and goodwill and other intangibles.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 3. SEGMENT INFORMATION -- (CONTINUED)

The Corporate and Other segment includes an equity ownership interest in Coventry Health Care, Inc. The Corporate and Other segment's equity in earnings of Coventry Health Care, Inc., which was included in net investment income, was \$9.7 million and \$10.8 million for the six months ended June 30, 2001 and 2000, respectively. The investment in Coventry Health Care, Inc. was \$134.6 million and \$122.9 million at June 30, 2001 and December 31, 2000, respectively. The Corporate and Other segment also includes consolidating and intersegment eliminations.

The Company's operations are not materially dependent on one or a few customers, brokers or agents, and revenues, assets and operating earnings are attributable to geographic location based on the country of domicile sales originate from.

## 4. PLAN OF DEMUTUALIZATION AND INITIAL PUBLIC OFFERING

On March 31, 2001, the Company's Board of Directors adopted a plan to convert Principal Mutual Holding Company from a mutual insurance holding company to a stock company. Adoption of the plan authorized management to implement the plan for demutualization of the Company. Upon demutualization, the membership interests of Principal Life's policyholders in Principal Mutual Holding Company will be extinguished, and eligible policyholders will receive compensation in exchange for the extinguishment of their membership interests. Their compensation will be in the form of common stock, cash or policy credits, depending upon the type of policy or policyholder.

Under Iowa insurance law, the plan also requires the approval of policyholders and the Insurance Commissioner of the State of Iowa. During June 2001, policyholders received the plan of conversion and Principal Financial Group, Inc. filed a registration statement with the Securities and Exchange Commission relating to a proposed initial public offering of common stock. The registration statement is expected to become effective in the latter part of 2001 or first part of 2002, when shares are expected to be sold to the public.

## 5. COMMITMENTS AND CONTINGENCIES

The Company is a plaintiff or defendant in actions arising out of its operations. The Company is, from time to time, also involved in various governmental and administrative proceedings. While the outcome of any pending or future litigation cannot be predicted, management does not believe that any pending litigation will have a material adverse effect on the Company's business, financial condition or results of operations. However, no assurances can be given that such litigation would not materially and adversely affect the Company's business, financial condition or results of operations.

Other companies in the life insurance industry have historically been subject to substantial litigation resulting from claims disputes and other matters. Most recently, such companies have faced extensive claims, including class-action lawsuits, alleging improper life insurance sales practices. Negotiated settlements of such class-action lawsuits have had a material adverse effect on the business, financial condition and results of operations of certain of these companies. Principal Life is currently a defendant in two class-action lawsuits which allege improper sales practices.

In 2000, the Company reached an agreement in principal to settle these two class-action lawsuits alleging improper sales practices. In April 2001, the proposed settlement of the class-action lawsuit received court approval. In agreeing to the settlement, the Company specifically denied any wrongdoing. The Company has accrued a loss reserve for its best estimate based on information available. As uncertainties continue to exist in resolving this matter, it is reasonably possible that, as the actual cost of the claims subject to alternative dispute resolution becomes available, the final cost of settlement could exceed the Company's estimate. The range of any additional cost related to the settlement cannot be presently estimated, however the Company believes the settlement will not have a material impact on its business, financial condition or results of operations. A number of persons and entities who were eligible to be class members have excluded themselves from the class (or "opted out"), as the law permits them to do. The Company has been notified that some of those who opted out from the class will file lawsuits and make claims similar to those addressed by the settlement.

The Company is also subject to insurance guaranty laws in the states in which it writes business. These laws provide for assessments against insurance companies for the benefit of policyholders and claimants in the event of insolvency of other insurance companies. The assessments may be partially recovered through a reduction in future premium taxes in some states. The Company believes such assessments in excess of amounts accrued would not materially affect its financial condition or results of operations.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 6. SUBSEQUENT EVENTS

## PLAN OF DEMUTUALIZATION

On July 24, 2001, Principal Life's policyholders approved the plan for demutualization. The plan was submitted to the Insurance Commissioner of the State of Iowa for approval and a public hearing was held on July 25, 2001. The Insurance Commissioner of the State of Iowa approved the plan of conversion on August 28, 2001.

## ACCOUNTING CHANGES

On July 20, 2001, the FASB issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"), which dramatically change the accounting for business combinations, goodwill and other intangible assets. These Statements are effective July 1, 2001, for any business combinations entered into subsequent to June 30, 2001. SFAS 142, which will become effective January 1, 2002, for the Company's business combinations entered into prior to June 30, 2001, adopts a nonamortization, impairment-only model for the Company's goodwill and indefinite-lived intangible assets. This includes a more stringent impairment test methodology for measuring and recognizing impairment losses. The Company is presently studying the impact the new Statements will have on its accounting policies.

## TERRORIST ATTACKS IN THE UNITED STATES

On September 11, 2001, terrorist attacks in the United States resulted in significant loss of life and property, as well as interruption of business activities and an overall disruption of the world economy. Management estimates that the Company's losses from insurance claims from these events, primarily individual life insurance claims, to be between \$9.0 million and \$12.0 million after taxes, taking into consideration reinsurance coverage. Management has estimated no material property or investment real estate loss exposures resulting from these events. However, the continuing impacts of these events on the world economy and financial markets cannot presently be determined. This creates related uncertainties as to the future realization of and return on certain invested assets; the impact on the Company's assumptions in assessing the value of intangibles from prior acquisitions and the amortization patterns for deferred policy acquisition costs; and the impact on future operating results, for which estimates cannot presently be made.

March 31, 2001

The Board of Directors  
Principal Mutual Holding Company  
711 High Street  
Des Moines, IA 50392-0650

Re: Plan of Conversion of Principal Mutual Holding Company

STATEMENT OF ACTUARIAL OPINION

SUBJECT OF THIS OPINION

This opinion letter relates to the actuarial aspects of the proposed Reorganization of Principal Mutual Holding Company ("Principal") pursuant to its Plan of Conversion (the "Plan") as presented to Principal's Board of Directors for its consideration and adoption on March 31, 2001. The specific opinion set forth herein relates to the proposed allocation of consideration among Eligible Policyholders as described in the Plan.

Capitalized terms have the same meaning in this opinion as they have in the Plan.

QUALIFICATIONS AND USAGE

I, Daniel J. McCarthy, am associated with the firm of Milliman & Robertson, Inc., ("M&R") and am a Member of the American Academy of Actuaries, qualified under the Academy's Qualification Standards to render the opinions set forth herein. I and other M&R staff acting under my direction have advised Principal during the course of its development of the Plan and the Actuarial Contribution Memorandum, an Exhibit thereto. The Plan is based on authority in Sections 521A.14(5)(b) and 508B.2 of Title XIII of the Code of Iowa (2001). The opinions set forth herein are not legal opinions concerning the Plan but rather reflect the application of actuarial concepts and standards of practice to the provisions thereof.

I am aware that this opinion letter will be furnished to the Commissioner of Insurance of the State of Iowa for her use in determining the fairness of the Plan, and to Principal's Members as part of the Policyholder Information Booklet that will be delivered to them, and I consent to the use of this letter for those purposes.

RELIANCE

In forming the opinions set forth in this memorandum, I have received from Principal extensive information concerning the past and present practices and financial results of Principal Life Insurance Company ("Principal Life"), formerly known as Principal Mutual Life Insurance Company and Bankers Life Company. This information includes actuarial studies and projected asset cash flows developed by Principal Life staff. I, and other M&R staff acting under my direction, met with Principal personnel and defined the information

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we required; in all cases, we were provided with the information we requested to the extent that it was available or could be developed from Principal Life's records. We have made no independent verification of this information, although we have reviewed it where practicable for general reasonableness and internal consistency. I have relied on this information, which was provided under the general direction of Ellen Lamale, Principal Life's Senior Vice President & Chief Actuary. My opinions depend on the substantial accuracy of this information.

#### PROCESS

In all cases, I and other M&R staff acting under my direction either derived the results on which my opinions rest or reviewed derivations carried out by Principal Life employees.

#### OPINION

Under the Plan, consideration (shares of Common Stock of Principal Financial Group Inc., or their equivalent value in cash or policy credits) is to be distributed to each Eligible Policyholder in exchange for the Eligible Policyholder's Membership Interest. In my opinion, the principles, assumptions, and methodologies used to allocate consideration among Principal's Eligible Policyholders, as set forth in Article VII of the Plan (including the Actuarial Contribution Memorandum, an Exhibit thereto) are reasonable and appropriate and result in an allocation of consideration that is fair and equitable to the Eligible Policyholders.

#### DISCUSSION

General description of the method of allocation. Under the Plan, each Eligible Policyholder will be allocated a fixed component of consideration; i.e., a value, expressed in terms of shares of Common Stock, that is independent of the Eligible Policyholder's Actuarial Contribution. In addition, each Eligible Policyholder will be allocated a variable component of consideration if the Actuarial Contribution of any of the Policies owned by the Eligible Policyholder is positive. As defined in the Plan, Actuarial Contribution means, with respect to a particular Policy, the contribution that such Policy is estimated to have made to Principal Life's surplus and asset valuation reserve, plus the contribution that such Policy is expected to make in the future, calculated in each case according to the principles, assumptions and methodologies set forth in Article VII of the Plan and the Actuarial Contribution Memorandum.

For each Eligible Policyholder who receives a variable component of consideration, the amount of such consideration is equal to:

(a) the sum of the positive Actuarial Contributions of all Policies owned by the Eligible Policyholder, multiplied by

(b) the ratio of the Aggregate Variable Component to the sum of the positive Actuarial Contributions of all Policies,

subject to rounding rules described in the Plan.

Appropriateness of the "actuarial contribution" method. Most of the consideration allocated to Eligible Policyholders is allocated via the Aggregate Variable Component, using the "actuarial contribution" method described above. The previously cited Sections of the Code of Iowa do not provide any specific guidance as to the method of allocation; it is therefore appropriate to consider applicable professional literature when considering the appropriateness of an allocation method. The actuarial contribution method is recognized in the actuarial literature as an appropriate allocation method. In particular, Actuarial Standard of Practice 37, "Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations" ("ASOP 37"), which is the most authoritative professional guidance available to actuaries on this subject, states in part, "The variable component of consideration should be allocated on the basis of the actuarial contribution." ASOP 37 defines "actuarial contribution," in relevant part, to be "The contributions that a particular policy ... has made to the company's statutory surplus and asset valuation reserve, plus the present value of contributions that the same policy ... is expected to make in the future." This is consistent with the definition in the Plan. I therefore find that the use of "actuarial contribution" as the principal basis underlying the allocation of consideration is appropriate. I further find that, in the Plan, the actuarial contribution method has been implemented in a reasonable manner, through the use of methods and assumptions that are reasonable and appropriate, consistent with Principal's past and present business practices and relevant actuarial literature and, in particular, consistent with methods and assumptions prescribed or permitted by ASOP 37.

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Discounting of expected future contributions to surplus. In determining the portion of a policy's Actuarial Contribution that arises from its expected future contribution to surplus, ASOP 37 provides that such contributions may be discounted to present value using either the expected after-tax rate of investment return or "... a risk-adjusted rate appropriate for the line of business or type of policy involved." Principal has chosen the latter course, and has selected risk-adjusted rates of return generally consistent with Principal Life's pricing objectives or, in the instance of policies in the Closed Block, consistent with the funding of the Closed Block. I find that this use of risk-adjusted rates of return is appropriate, and that the rates of return selected are reasonable.

The effect of the Closed Block. As is set forth in Article II of the Plan, Principal Life formed and began operating a Closed Block coincident with the reorganization of Principal Mutual Life Insurance Company to a mutual holding company structure effective July 1, 1998. After the conversion of the MIHC, Principal Life will continue to operate the Closed Block in accordance with its terms as originally established. Principal has -- in calculating the Actuarial Contribution of each Closed Block policy -- estimated the contribution that each such policy is expected to make to Principal Life's surplus and asset valuation reserve from the date of the Closed Block's establishment forward by using assumptions that are consistent with those used in the funding of the Closed Block, with further adjustments to reflect the effect of future operating expenses that were not funded for in the Closed Block. I find that this is an appropriate manner in which to determine the expected future contributions to Principal Life's surplus and asset valuation reserve arising from Closed Block policies.

Appropriateness of the fixed component. Consideration is also allocated to Eligible Policyholders via the fixed component, through which each Eligible Policyholder is allocated a fixed number of shares of Common Stock without regard to the Actuarial Contribution of Policies owned by that Eligible Policyholder. This element of the allocation assures that each Eligible Policyholder will receive some distribution, and is consistent with overall concepts of equity. Under the Plan, the percentage of the total consideration that is allocated in this manner is small relative to that allocated in proportion to positive actuarial contributions, which is appropriate. I find that including a minimum allocation to each Eligible Policyholder using the fixed component is reasonable and appropriate, and that the size of the fixed component to be distributed to each Eligible Policyholder as set forth in the Plan, and the overall portion of consideration allocated among Eligible Policyholders via the fixed component -- approximately one-fourth of the total -- are reasonable. In making this finding, I have taken into account the guidance provided in ASOP 37. In particular, I have taken into account the treatment of the fixed component -- both as to the size of the fixed component received by each Eligible Policyholder and as to the overall portion of consideration allocated via the fixed component -- in prior demutualizations of mutual life insurance companies.

Appropriateness of the definition of "Eligible Policyholder." In considering the fairness of the allocation, I have taken into account the definition of "Eligible Policyholder" set forth in the Plan. Principal's definition is influenced in part by Iowa law, in part by the company's manner of operation (including the sale of certain classes of business through Company Trusts), in part by the provisions of Principal's By-laws, and in part by precedent from prior demutualizations. Taking into account these influences, I find the definition of Eligible Policyholder to be reasonable and appropriate.

Yours sincerely,

/s/ Daniel J. McCarthy  
Daniel J. McCarthy

MILLIMAN & ROBERTSON, INC.

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 No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus. You must not rely on any unauthorized information or representations. This prospectus is an offer to sell only the shares offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus is current only as of its date.

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 Through and including November 16, 2001 (the 25th day after the date of this prospectus), all dealers effecting transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to a dealer's obligation to deliver a prospectus when acting as an underwriter and with respect to an unsold allotment or subscription.

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 -----  
 100,000,000 Shares

PRINCIPAL FINANCIAL  
 GROUP, INC.

Common Stock

-----  
 [PRINCIPAL FINANCIAL GROUP LOGO]

-----  
 GOLDMAN, SACHS & CO.

CREDIT SUISSE FIRST BOSTON  
 MERRILL LYNCH & CO.  
 SALOMON SMITH BARNEY

BANC OF AMERICA SECURITIES LLC  
 BEAR, STEARNS & CO. INC.  
 A.G. EDWARDS & SONS, INC.  
 FOX-PITT, KELTON  
 JPMORGAN  
 LEHMAN BROTHERS  
 RAMIREZ & CO., INC.  
 UBS WARBURG

Representatives of the Underwriters

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[Alternate Page to International Prospectus]

[PRINCIPAL FINANCIAL GROUP LOGO]

100,000,000 Shares  
PRINCIPAL FINANCIAL GROUP, INC.  
Common Stock

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This is an initial public offering of 100,000,000 shares of common stock of Principal Financial Group, Inc. This offering is being made in connection with the conversion of Principal Mutual Holding Company from a mutual insurance holding company into a stock company in a process called a demutualization. After the demutualization, Principal Financial Group, Inc. will indirectly own all of the outstanding common stock of Principal Life Insurance Company.

This prospectus relates to an offering of 15,000,000 shares in an international offering outside the United States. In addition, 85,000,000 shares are being offered in an United States offering.

In addition to these shares, Principal Financial Group, Inc. will issue an estimated 260.6 million shares of its common stock to policyholders entitled to receive shares in the demutualization in exchange for their membership interests in Principal Mutual Holding Company, or to a separate account for the benefit of those policyholders.

Prior to this offering there has been no public market for the common stock. The common stock of Principal Financial Group, Inc. has been approved for listing on the New York Stock Exchange under the symbol "PFG", subject to official notice of issuance.

See "Risk Factors" on page 12 to read about factors you should consider before buying shares of the common stock.

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NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY OTHER REGULATORY BODY HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Per Share	Total
	-----	-----
Initial public offering price.....	\$ 18.50	\$1,850,000,000
Underwriting discount.....	\$ 0.805	\$ 80,475,000
Proceeds, before expenses, to Principal Financial Group, Inc. ....	\$ 17.695	\$1,769,525,000

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To the extent the international underwriters sell more than 15,000,000 shares of common stock, the underwriters have the option to purchase up to an additional 2,250,000 shares from Principal Financial Group, Inc. at the initial public offering price less the underwriting discount. The U.S. underwriters have a similar option to purchase up to 12,750,000 additional shares of common stock.

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The international underwriters expect to deliver the shares against payment in New York, New York on October 26, 2001.

GOLDMAN SACHS INTERNATIONAL  
CREDIT SUISSE FIRST BOSTON  
MERRILL LYNCH INTERNATIONAL  
SALOMON SMITH BARNEY

BANC OF AMERICA SECURITIES LIMITED  
A.G. EDWARDS & SONS, INC.  
JPMORGAN  
RAMIREZ & CO., INC.

BEAR, STEARNS INTERNATIONAL LIMITED  
FOX-PITT, KELTON  
LEHMAN BROTHERS  
UBS WARBURG

ABN AMRO ROTHSCHILD  
COMMERZBANK SECURITIES

BNP PARIBAS  
CREDIT LYONNAIS

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Prospectus dated October 22, 2001.

## UNDERWRITING

Principal Financial Group, Inc. and the underwriters for the international offering named below, referred to as the international underwriters, have entered into an underwriting agreement with respect to the shares offered outside the United States. Subject to certain conditions, each international underwriter has severally agreed to purchase the number of shares indicated in the following table.

International underwriters -----	Number of Shares -----
Goldman Sachs International.....	3,562,500
Credit Suisse First Boston (Europe) Limited.....	1,710,000
Merrill Lynch International.....	1,638,750
Salomon Brothers International Limited.....	1,638,750
Banc of America Securities Limited.....	712,500
Bear, Stearns International Limited.....	712,500
A.G. Edwards & Sons, Inc.....	712,500
Fox-Pitt, Kelton N.V.....	712,500
J.P. Morgan Securities Ltd.....	712,500
Lehman Brothers International (Europe).....	712,500
Samuel A. Ramirez & Company, Inc.....	712,500
UBS AG, acting through its business group UBS Warburg.....	712,500
ABN AMRO Rothschild.....	187,500
BNP Paribas.....	187,500
Commerzbank Aktiengesellschaft.....	187,500
Credit Lyonnais.....	187,500
	-----
Total.....	15,000,000 =====

If the international underwriters sell more shares than the total number listed in the table above, the international underwriters have an option to buy up to an additional 2,250,000 shares from Principal Financial Group, Inc. to cover such sales. They may exercise that option for 30 days. If any shares are purchased under this option, the international underwriters will severally purchase shares in approximately the same proportion as shown in the table above.

The following table shows the per share and total underwriting discounts and commissions to be paid to the international underwriters by Principal Financial Group, Inc. Such amounts are shown assuming both no exercise and full exercise of the international underwriters' option to purchase 2,250,000 additional shares.

Paid by Principal Financial Group, Inc.

	No Exercise -----	Full Exercise -----
Per Share.....	\$ 0.805	\$ 0.805
Total.....	\$12,071,250	\$13,881,938

Shares sold by the international underwriters to the public will initially be offered at the initial public offering price provided on the cover of this prospectus. Any shares sold by the international underwriters to securities dealers may be sold at a discount of up to \$0.49 per share from the initial public offering price. Any such securities dealers may resell any shares purchased from the international underwriters to certain other brokers or dealers at a discount of up to \$0.10 per share from the initial public offering price. If all the shares are not sold at the initial offering price, the international underwriters may change the offering price and the other selling terms.

Principal Financial Group, Inc. has entered into an underwriting agreement with underwriters for the sale of 85,000,000 shares in the United States. The terms and conditions of both offerings are the same and the sale of shares in both offerings are conditioned on each other. Goldman, Sachs & Co., Credit Suisse First Boston Corporation, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Salomon Smith Barney Inc., Banc of America Securities LLC, Bear, Stearns & Co. Inc., A.G. Edwards & Sons, Inc., Fox-Pitt, Kelton Inc., J.P. Morgan Securities Inc., Lehman Brothers Inc., Samuel A. Ramirez & Company, Inc., and UBS Warburg LLC are the representatives of the underwriters for the offering in the United States, referred to as the U.S. underwriters. Principal Financial Group, Inc. has granted the U.S. underwriters a similar option to purchase up to an aggregate of an additional 12,750,000 shares.

The underwriters for both of the offerings will enter into an agreement in which they will agree to restrictions on where and to whom they and any dealer purchasing from them may offer shares as a part of the distribution of the shares. The underwriters will also agree that they may sell shares among each of the underwriting groups.

Principal Financial Group, Inc. has agreed with the underwriters not to dispose of or hedge any shares of common stock or securities convertible into or exchangeable for shares of common stock during the period from the date of this prospectus continuing through the date 180 days after the date of this prospectus, except with the prior written consent of the representatives. This restriction does not apply to: (1) shares of our common stock issued to a new separate account of Principal Life, held for the benefit of Qualified Plan Customers, as part of the Separate Account Policy Credits and (2) employee stock option plans existing on, or upon the conversion or exchange of convertible or exchangeable securities outstanding as of, the date of the underwriting agreement. See "Common Stock Eligible for Future Sale" for a discussion of transfer restrictions.

Prior to the offering, there has been no public market for the shares. The initial public offering price has been negotiated among us and the representatives. Among the factors to be considered in determining the initial public offering price of the shares, in addition to prevailing market conditions, will be the historical performance of Principal Financial Group, Inc., estimates of its business potential and earnings prospects, an assessment of its management and the consideration of the above factors in relation to market valuation of companies in related businesses.

The common stock of Principal Financial Group, Inc. has been approved for listing on the New York Stock Exchange under the symbol "PFG", subject to official notice of issuance.

In connection with the offering, the underwriters may purchase and sell shares of common stock in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering. "Covered" short sales are sales made in an amount not greater than the underwriters' option to purchase additional shares from us in the offering. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the overallotment option. "Naked" short sales are any sales in excess of such option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the common stock in the open market after pricing that could adversely affect investors who purchase in the offering. Stabilizing transactions consist of various bids for or purchases of common stock made by the underwriters in the open market prior to the completion of the offering.

The underwriters may also impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the representatives have repurchased shares sold by or for the account of such underwriter in stabilizing or short covering transactions.

Purchases to cover a short position and stabilizing transactions may have the effect of preventing or retarding a decline in the market price of the common stock, and together with the imposition of the penalty bid may stabilize, maintain or otherwise affect the market price of the common stock. As a result, the price of the common stock may be higher than the price that otherwise might exist in the open market. If these activities are commenced, they may be discontinued at any time. These transactions may be effected on the New York Stock Exchange, in the over-the-counter market or otherwise.

Each international underwriter has also represented and agreed that (i) it has not offered or sold and, prior to the date six months after the date of issue of the shares of common stock, will not offer or sell any shares of common stock to persons in the United Kingdom, except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances that have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995; (ii) it has complied, and will comply with, all applicable provisions of the Financial Services Act 1986 of Great Britain with respect to anything done by it in relation to the shares of common stock in, from or otherwise involving the United Kingdom; and (iii) it has only issued or passed on and will only issue or pass on in the United Kingdom any document received by it in connection with the issuance of the shares of common stock to a person who is of a kind described in Article 11(3) of the Financial Services Act 1986 (Investment Advertisements) (Exemptions) Order 1996 (as amended) of Great Britain or is a person to whom the document may otherwise lawfully be issued or passed on.

The shares of common stock may not be offered, sold, transferred or delivered in or from The Netherlands, as part of their initial distribution or as part of any re-offering, and neither this prospectus nor any other document in respect of the offering may be distributed or circulated in The Netherlands, other than to individuals or legal entities which include, but are not limited to, banks, brokers, dealers, institutional investors and undertakings with a



treasury department, who or which trade or invest in securities in the conduct of a business or profession.

Each international underwriter has acknowledged and agreed that the shares of common stock have not been registered under the Securities and Exchange Law of Japan and are not being offered or sold and may not be offered or sold, directly or indirectly, in Japan or to or for the account of any resident of Japan, except (i) pursuant to an exemption from the registration requirements of the Securities and Exchange Law of Japan and (ii) in compliance with any other applicable requirements of Japanese law. As part of the offering, the underwriters may offer the shares of common stock in Japan to a list of 49 offerees in accordance with the above provisions.

The underwriters do not expect sales to discretionary accounts to exceed five percent of the total number of shares offered.

A prospectus in electronic format will be made available on the web sites maintained by one or more of the lead managers of this offering and may also be made available on web sites maintained by other underwriters. The underwriters may agree to allocate a number of shares to underwriters for sale to their online brokerage account holders. Internet distributions will be allocated by the lead managers to underwriters that may make Internet distributions on the same basis as other allocations.

Principal Financial Group, Inc. estimates that its share of the total expenses of this offering, excluding underwriting discounts and commissions, will be approximately \$16.2 million.

Principal Financial Group, Inc. and Principal Life Insurance Company have agreed to, jointly and severally, indemnify the several underwriters against certain liabilities, including liabilities under the Securities Act of 1933.

Certain of the underwriters and their affiliates have in the past provided, and may in the future from time to time provide, investment banking and general financing and banking services to Principal Financial Group, Inc. and its affiliates for which they have received in the past and may in the future receive, customary fees.

This prospectus may be used by the underwriters and other dealers in connection with offers and sales of the shares, including sales of shares initially sold by the underwriters in the offering being made outside of the United States, to persons located in the United States.

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