AMERICAN EQUITY INVESTMENT LIFE HOLDING CO
Form 10-Q
November 09, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________
Commission File Number : 001-31911
American Equity Investment Life Holding Company
(Exact name of registrant as specified in its charter)

Iowa	42-1447959
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6000 Westown Parkway
West Des Moines, Iowa 50266
(Address of principal executive offices, including zip code)
(515) 221-0002
(Registrant's telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer," “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
APPLICABLE TO CORPORATE ISSUERS:
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:
As of November 7, 2016, there were 88,066,714 shares of the registrant's common stock, $1 par value, outstanding.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share and per share data)

	September 30, 2016 (Unaudited)	December 31, 2015
Assets		
Investments:		
Fixed maturity securities:		
Available for sale, at fair value (amortized cost: 2016 - $39,199,077; 2015 - $35,823,710)	$ 42,304,410	$ 36,421,839
Held for investment, at amortized cost (fair value: 2016 - $75,547; 2015 - $65,377)	76,773	76,622
Equity securities, available for sale, at fair value (cost: 2016 - $7,520; 2015 - $7,515)	7,843	7,828
Mortgage loans on real estate	2,419,230	2,435,257
Derivative instruments	706,007	337,256
Other investments	297,068	291,530
Total investments	45,811,331	39,570,332
Cash and cash equivalents	812,814	397,749
Coinsurance deposits	4,453,320	3,187,470
Accrued investment income	405,996	362,104
Deferred policy acquisition costs	2,370,781	2,905,136
Deferred sales inducements	1,800,435	2,232,148
Deferred income taxes	—	232,683
Income taxes recoverable	12,652	29,599
Other assets	180,892	112,171
Total assets	$ 55,848,221	$ 49,029,392
Liabilities and Stockholders' Equity		
Liabilities:		
Policy benefit reserves	$ 50,814,665	$ 45,495,431
Other policy funds and contract claims	302,849	324,850
Notes and loan payable	493,445	393,227
Subordinated debentures	241,751	241,452
Deferred income taxes	110,551	—
Other liabilities	1,072,098	629,897
Total liabilities	53,035,359	47,084,857
Stockholders' equity:		
Preferred stock, par value $1 per share, 2,000,000 shares authorized, 2016 and 2015 - no shares issued and outstanding	—	—
Common stock, par value $1 per share, 200,000,000 shares authorized; issued and outstanding: 2016 - 87,898,452 shares (excluding 3,221,258 treasury shares); 2015 - 81,354,079 shares (excluding 3,448,750 treasury shares)	87,898	81,354

Additional paid-in capital	767,570	630,367
Accumulated other comprehensive income	963,796	201,663
Retained earnings	993,598	1,031,151
Total stockholders' equity	2,812,862	1,944,535
Total liabilities and stockholders' equity	$ 55,848,221	$ 49,029,392

See accompanying notes to unaudited consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues:				
Premiums and other considerations	$12,731	$8,335	$31,534	$25,369
Annuity product charges	47,675	37,975	125,304	99,066
Net investment income	463,583	436,085	1,374,239	1,253,930
Change in fair value of derivatives	103,794	(351,360)	68,828	(405,484)
Net realized gains (losses) on investments, excluding other than temporary impairment ("OTTI") losses	5,256	1,159	10,680	10,362
OTTI losses on investments:				
Total OTTI losses	(4,554)	(10,000)	(11,334)	(10,132)
Portion of OTTI losses recognized in (from) other comprehensive income	1,575	4,771	(1,785)	3,943
Net OTTI losses recognized in operations	(2,979)	(5,229)	(13,119)	(6,189)
Total revenues	630,060	126,965	1,597,466	977,054
Benefits and expenses:				
Insurance policy benefits and change in future policy benefits	15,065	10,959	37,567	32,629
Interest sensitive and index product benefits	278,943	213,465	487,735	802,431
Amortization of deferred sales inducements	69,245	65,807	127,396	152,278
Change in fair value of embedded derivatives	144,404	(414,724)	694,564	(583,112)
Interest expense on notes and loan payable	6,887	7,283	20,649	21,976
Interest expense on subordinated debentures	3,253	3,075	9,627	9,138
Amortization of deferred policy acquisition costs	98,108	67,885	198,486	186,871
Other operating costs and expenses	25,133	24,497	78,786	70,487
Total benefits and expenses	641,038	(21,753)	1,654,810	692,698
Income (loss) before income taxes	(10,978)	148,718	(57,344)	284,356
Income tax expense (benefit)	(3,558)	51,412	(19,791)	98,302
Net income (loss)	$(7,420)	$97,306	$(37,553)	$186,054
Earnings (loss) per common share	$(0.09)	$1.22	$(0.45)	$2.39
Earnings (loss) per common share - assuming dilution	$(0.09)	$1.19	$(0.45)	$2.33
Weighted average common shares outstanding (in thousands):				
Earnings (loss) per common share	86,262	79,676	83,645	77,995
Earnings (loss) per common share - assuming dilution	87,044	81,559	84,413	79,977

See accompanying notes to unaudited consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income (loss)	$(7,420)	$97,306	$(37,553)	$186,054
Other comprehensive income (loss):				
Change in net unrealized investment gains/losses (1)	107,003	60,402	1,167,763	(453,582)
Noncredit component of OTTI losses (1)	(731)	(2,381)	835	(1,968)
Reclassification of unrealized investment gains/losses to net income (loss) (1)	2,287	96	3,914	1,940
Other comprehensive income (loss) before income tax	108,559	58,117	1,172,512	(453,610)
Income tax effect related to other comprehensive income (loss)	(37,995)	(20,341)	(410,379)	158,764
Other comprehensive income (loss)	70,564	37,776	762,133	(294,846)
Comprehensive income (loss)	$63,144	$135,082	$724,580	$(108,792)

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

See accompanying notes to unaudited consolidated financial statements.

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AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Dollars in thousands, except share data)
(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders' Equity
Balance at December 31, 2015	$ 81,354	$ 630,367	$ 201,663	$ 1,031,151	$ 1,944,535
Net loss for period	—	—	—	(37,553)	(37,553)
Other comprehensive income	—	—	762,133	—	762,133
Share-based compensation, including excess income tax benefits	—	5,335	—	—	5,335
Issuance of common stock via settlement of forward sale agreements	5,590	129,072	—	—	134,662
Issuance of 861,375 shares of common stock under compensation plans, including excess income tax benefits	861	2,890	—	—	3,751
Issuance of 92,998 shares of common stock to settle warrants that have reached their expiration	93	(94)	—	—	(1)
Balance at September 30, 2016	$ 87,898	$ 767,570	$ 963,796	$ 993,598	$ 2,812,862
Balance at December 31, 2014	$ 76,062	$ 513,218	$ 721,401	$ 829,195	$ 2,139,876
Net income for period	—	—	—	186,054	186,054
Other comprehensive loss	—	—	(294,846)	—	(294,846)
Share-based compensation, including excess income tax benefits	—	7,567	—	—	7,567
Issuance of common stock via public offering	4,300	100,179	—	—	104,479
Issuance of 828,529 shares of common stock under compensation plans, including excess income tax benefits	829	5,950	—	—	6,779
Balance at September 30, 2015	$ 81,191	$ 626,914	$ 426,555	$ 1,015,249	$ 2,149,909

See accompanying notes to unaudited consolidated financial statements.

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

	Nine Months Ended September 30,	
	2016	2015
Operating activities		
Net income (loss)	$(37,553)	$186,054
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Interest sensitive and index product benefits	487,735	802,431
Amortization of deferred sales inducements	127,396	152,278
Annuity product charges	(125,304)	(99,066)
Change in fair value of embedded derivatives	694,564	(583,112)
Change in traditional life and accident and health insurance reserves	8,977	3,024
Policy acquisition costs deferred	(423,525)	(464,451)
Amortization of deferred policy acquisition costs	198,486	186,871
Provision for depreciation and other amortization	3,000	3,733
Amortization of discounts and premiums on investments	(2,258)	(10,730)
Realized gains (losses) on investments and net OTTI losses recognized in operations	2,439	(4,173)
Change in fair value of derivatives	(70,002)	404,085
Deferred income taxes	(66,895)	23,640
Share-based compensation	4,849	5,332
Change in accrued investment income	(43,892)	(48,963)
Change in income taxes recoverable/payable	16,947	4,794
Change in other assets	1,930	1,053
Change in other policy funds and contract claims	(27,627)	(36,876)
Change in collateral held for derivatives	254,210	(469,752)
Change in other liabilities	(48,608)	24,766
Other	(10,363)	(9,843)
Net cash provided by operating activities	944,506	71,095
Investing activities		
Sales, maturities, or repayments of investments:		
Fixed maturity securities - available for sale	1,853,281	1,280,927
Mortgage loans on real estate	302,262	354,391
Derivative instruments	147,887	563,125
Other investments	12,928	11,716
Acquisition of investments:		
Fixed maturity securities - available for sale	(5,065,873)	(5,041,263)
Mortgage loans on real estate	(284,186)	(362,123)
Derivative instruments	(444,360)	(427,763)
Other investments	(9,778)	(5,206)
Purchases of property, furniture and equipment	(872)	(913)
Net cash used in investing activities	(3,488,711)	(3,627,109)

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

	Nine Months Ended September 30,	
	2016	2015
Financing activities		
Receipts credited to annuity and single premium universal life policyholder account balances	$5,712,759	$4,913,473
Coinsurance deposits	(1,180,827)	21,623
Return of annuity policyholder account balances	(1,806,895)	(1,638,598)
Financing fees incurred and deferred	(1,456)	—
Repayment of notes payable	—	(48,152)
Net proceeds from settlement of notes hedges and warrants	—	25,775
Proceeds from issuance of debt	100,000	—
Acquisition of common stock	—	(16)
Excess tax benefits realized from share-based compensation plans	487	3,281
Proceeds from issuance of common stock	138,660	111,274
Change in checks in excess of cash balance	(3,458)	(10,546)
Net cash provided by financing activities	2,959,270	3,378,114
Increase in cash and cash equivalents	415,065	(177,900)
Cash and cash equivalents at beginning of period	397,749	701,514
Cash and cash equivalents at end of period	$812,814	$523,614
Supplemental disclosures of cash flow information		
Cash paid during period for:		
Interest expense	$35,764	$36,136
Income taxes	29,961	66,541
Non-cash operating activity:		
Deferral of sales inducements	270,991	346,410
Non-cash financing activities:		
Common stock issued to settle warrants that have expired	93	—

See accompanying notes to unaudited consolidated financial statements.

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AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2016
(Unaudited)

1. Significant Accounting Policies

Consolidation and Basis of Presentation

The accompanying consolidated financial statements of American Equity Investment Life Holding Company (“we”, “us” or “our”) have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and notes required by GAAP for complete financial statements. The consolidated financial statements reflect all adjustments, consisting only of normal recurring items, which are necessary to present fairly our financial position and results of operations on a basis consistent with the prior audited consolidated financial statements. Operating results for the three and nine month periods ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ended December 31, 2016. All significant intercompany accounts and transactions have been eliminated. The preparation of financial statements requires the use of management estimates. For further information related to a description of areas of judgment and estimates and other information necessary to understand our financial position and results of operations, refer to the audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2015.

Adopted Accounting Pronouncements

In April 2015, the Financial Accounting Standards Board ("FASB") issued an accounting standards update ("ASU") which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. Subsequently, in August 2015, the FASB issued an ASU that states that the Securities and Exchange Commission staff would not object to an entity deferring and presenting debt issuance costs related to line-of-credit arrangements as an asset and expensing those costs ratably over the term of the line of credit arrangement. These ASU's became effective for us on January 1, 2016, and retroactive application is required. They did not have a material impact on our consolidated financial statements.

New Accounting Pronouncements

In January 2016, the FASB issued an ASU that, among other aspects of recognition, measurement, presentation and disclosure of financial instruments, primarily requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Additionally, it changes the accounting for financial liabilities measured at fair value under the fair value option and eliminates some disclosures regarding fair value of financial assets and liabilities measured at amortized cost. This ASU will be effective for us on January 1, 2018, and we have not determined the effect it will have on our consolidated financial statements.

In February 2016, the FASB issued an ASU that will require recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This ASU affects accounting and disclosure more dramatically for lessees as accounting for lessors is mainly unchanged. This ASU will be effective for us on January 1, 2019, with early adoption permitted, and we have not determined the effect it will have on our consolidated financial statements.

In March 2016, the FASB issued an ASU related to the accounting for share-based payment transactions. The aspects of accounting guidance affected by this ASU are income taxes, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This ASU will be effective for us on January 1, 2017, with early adoption permitted, and we have not determined the effect it will have on our consolidated financial statements.

In June 2016, the FASB issued an ASU that significantly changes the impairment model for most financial assets that are measured at amortized cost and certain other instruments from an incurred loss model to an expected loss model that requires these assets be presented at the net amount expected to be collected. In addition, credit losses on available for sale debt securities should be recorded through an allowance account. This ASU will be effective for us on January 1, 2020, with early adoption permitted, and we have not yet determined the impact this updated guidance will have on our consolidated financial statements.

In August 2016, the FASB issued an ASU that clarifies how certain cash receipts and cash payments are to be presented and classified in the statement of cash flows. This ASU will be effective for us on January 1, 2018, with early adoption permitted, and we have not yet determined the impact this updated guidance will have on our consolidated financial statements.

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2. Fair Values of Financial Instruments

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

	September 30, 2016		December 31, 2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(Dollars in thousands)			
Assets				
Fixed maturity securities:				
Available for sale	$42,304,410	$42,304,410	$36,421,839	$36,421,839
Held for investment	76,773	75,547	76,622	65,377
Equity securities, available for sale	7,843	7,843	7,828	7,828
Mortgage loans on real estate	2,419,230	2,446,247	2,435,257	2,471,864
Derivative instruments	706,007	706,007	337,256	337,256
Other investments	297,068	290,719	285,044	290,075
Cash and cash equivalents	812,814	812,814	397,749	397,749
Coinsurance deposits	4,453,320	3,997,317	3,187,470	2,860,882
Interest rate caps	307	307	1,410	1,410
Counterparty collateral	144,082	144,082	82,312	82,312
Liabilities				
Policy benefit reserves	50,461,717	42,237,613	45,151,460	38,435,515
Single premium immediate annuity (SPIA) benefit reserves	302,428	313,130	324,264	336,066
Notes and loan payable	493,445	520,800	393,227	417,752
Subordinated debentures	241,751	227,755	241,452	216,933
Interest rate swap	4,944	4,944	3,139	3,139

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

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

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

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

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

Transfers of securities among the levels occur at times and depend on the type of inputs used to determine fair value of each security. There were no transfers between levels during any period presented.

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Our assets and liabilities which are measured at fair value on a recurring basis as of September 30, 2016 and December 31, 2015 are presented below based on the fair value hierarchy levels:

	Total Fair Value	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
September 30, 2016				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$418,465	$411,408	$7,057	$ —
United States Government sponsored agencies	1,472,904	—	1,472,904	—
United States municipalities, states and territories	4,052,210	—	4,052,210	—
Foreign government obligations	254,420	—	254,420	—
Corporate securities	27,915,657	6	27,915,651	—
Residential mortgage backed securities	1,358,174	—	1,358,174	—
Commercial mortgage backed securities	5,310,156	—	5,310,156	—
Other asset backed securities	1,522,424	—	1,522,424	—
Equity securities, available for sale: finance, insurance and real estate	7,843	—	7,843	—
Derivative instruments	706,007	—	706,007	—
Cash and cash equivalents	812,814	812,814	—	—
Interest rate caps	307	—	307	—
Counterparty collateral	144,082	—	144,082	—
	$43,975,463	$1,224,228	$42,751,235	$ —
Liabilities				
Interest rate swap	$4,944	$—	$4,944	$ —
Fixed index annuities - embedded derivatives	6,678,102	—	—	6,678,102
	$6,683,046	$—	$4,944	$ 6,678,102
December 31, 2015				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$471,256	$438,598	$32,658	$ —
United States Government sponsored agencies	1,398,611	—	1,398,611	—
United States municipalities, states and territories	3,755,367	—	3,755,367	—
Foreign government obligations	212,565	—	212,565	—
Corporate securities	23,802,394	121	23,802,273	—
Residential mortgage backed securities	1,462,072	—	1,462,072	—
Commercial mortgage backed securities	4,174,396	—	4,174,396	—
Other asset backed securities	1,145,178	—	1,145,178	—
Equity securities, available for sale: finance, insurance and real estate	7,828	—	7,828	—
Derivative instruments	337,256	—	337,256	—
Cash and cash equivalents	397,749	397,749	—	—
Interest rate caps	1,410	—	1,410	—

Counterparty collateral	82,312	—	82,312	—
	$37,248,394	$836,468	$36,411,926	$ —
Liabilities				
Interest rate swap	$3,139	$—	$3,139	$ —
Fixed index annuities - embedded derivatives	5,983,622	—	—	5,983,622
	$5,986,761	$—	$3,139	$ 5,983,622

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

Fixed maturity securities and equity securities

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

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

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

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

We validate external valuations at least quarterly through a combination of procedures that include the evaluation of methodologies used by the pricing services, analytical reviews and performance analysis of the prices against trends, and maintenance of a securities watch list. Additionally, as needed we utilize discounted cash flow models or perform independent valuations on a case-by-case basis using inputs and assumptions similar to those used by the pricing services. Although we do identify differences from time to time as a result of these validation procedures, we did not make any significant adjustments as of September 30, 2016 and December 31, 2015.

Mortgage loans on real estate

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

Derivative instruments

The fair values of derivative instruments, primarily call options, are based upon the amount of cash that we will receive to settle each derivative instrument on the reporting date. These amounts are determined by our investment team using industry accepted valuation models and are adjusted for the nonperformance risk of each counterparty net of any collateral held. Inputs include market volatility and risk free interest rates and are used in income valuation techniques in arriving at a fair value for each option contract. The nonperformance risk for each counterparty is based upon its credit default swap rate. We have no performance obligations related to the call options purchased to fund our fixed index annuity policy liabilities.

Other investments

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

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Cash and cash equivalents
Amounts reported in the consolidated balance sheets for these instruments are reported at their historical cost which approximates fair value due to the nature of the assets assigned to this category.
Interest rate swap and caps
The fair values of our pay fixed/receive variable interest rate swap and our interest rate caps are obtained from third parties and are determined by discounting expected future cash flows using projected LIBOR rates for the term of the swap and caps.
Counterparty collateral
Amounts reported in other assets on the consolidated balance sheets for these instruments are reported at their historical cost which approximates fair value due to the nature of the assets assigned to this category.
Policy benefit reserves, coinsurance deposits and SPIA benefit reserves
The fair values of the liabilities under contracts not involving significant mortality or morbidity risks (principally deferred annuities), are stated at the cost we would incur to extinguish the liability (i.e., the cash surrender value) as these contracts are generally issued without an annuitization date. The coinsurance deposits related to the annuity benefit reserves have fair values determined in a similar fashion. For period-certain annuity benefit contracts, the fair value is determined by discounting the benefits at the interest rates currently in effect for newly purchased immediate annuity contracts. We are not required to and have not estimated the fair value of the liabilities under contracts that involve significant mortality or morbidity risks, as these liabilities fall within the definition of insurance contracts that are exceptions from financial instruments that require disclosures of fair value. Policy benefit reserves, coinsurance deposits and SPIA benefit reserves are not measured at fair value on a recurring basis. All of the fair values presented within these categories fall within Level 3 of the fair value hierarchy as most of the inputs are unobservable market data.
Notes and loan payable
The fair values of our senior unsecured notes are based upon pricing matrices developed by a third party pricing service when quoted market prices are not available and are categorized as Level 2 within the fair value hierarchy. Fair value of our term loan is equal to the principal amount outstanding as the loan was originated on September 30, 2016. Notes and loan payable are not remeasured at fair value on a recurring basis.
Subordinated debentures
Fair values for subordinated debentures are estimated using discounted cash flow calculations based principally on observable inputs including our incremental borrowing rates, which reflect our credit rating, for similar types of borrowings with maturities consistent with those remaining for the debt being valued. These fair values are categorized as Level 2 within the fair value hierarchy. Subordinated debentures are not measured at fair value on a recurring basis.
Fixed index annuities - embedded derivatives
We estimate the fair value of the embedded derivative component of our fixed index annuity policy benefit reserves at each valuation date by (i) projecting policy contract values and minimum guaranteed contract values over the expected lives of the contracts and (ii) discounting the excess of the projected contract value amounts at the applicable risk free interest rates adjusted for our nonperformance risk related to those liabilities. The projections of policy contract values are based on our best estimate assumptions for future policy growth and future policy decrements. Our best estimate assumptions for future policy growth include assumptions for the expected index credit on the next policy anniversary date which are derived from the fair values of the underlying call options purchased to fund such index credits and the expected costs of annual call options we will purchase in the future to fund index credits beyond the next policy anniversary. The projections of minimum guaranteed contract values include the same best estimate assumptions for policy decrements as were used to project policy contract values.
Within this determination we have the following significant unobservable inputs: 1) the expected cost of annual call options we will purchase in the future to fund index credits beyond the next policy anniversary and 2) our best estimates for future policy decrements, primarily lapse, partial withdrawal and mortality rates. As of September 30, 2016 and December 31, 2015, we utilized an estimate of 3.10% for the expected cost of annual call options, which are based on estimated account value growth and a historical review of our actual option costs.

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Our best estimate assumptions for lapse, partial withdrawal and mortality rates are based on our actual experience and our outlook as to future expectations for such assumptions. These assumptions, which are consistent with the assumptions used in calculating deferred policy acquisition costs and deferred sales inducements, are reviewed on a quarterly basis and are revised as our experience develops and/or as future expectations change. Our mortality rate assumptions are based on 65% of the 1983 Basic Annuity Mortality Tables. The following table presents average lapse rate and partial withdrawal rate assumptions, by contract duration, used in estimating the fair value of the embedded derivative component of our fixed index annuity policy benefit reserves at each reporting date:

	Average Lapse Rates		Average Partial Withdrawal Rates	
Contract Duration (Years)	September 30, 2016	December 31, 2015	September 30, 2016	December 31, 2015
1 - 5	1.76%	1.58%	3.30%	3.08%
6 - 10	6.59%	8.55%	3.30%	3.55%
11 - 15	11.25%	12.01%	3.32%	3.59%
16 - 20	12.03%	12.99%	3.18%	3.22%
20+	11.68%	12.54%	3.18%	3.22%

Lapse rates are generally expected to increase as surrender charge percentages decrease. Lapse expectations reflect a significant increase in the year in which the surrender charge period on a contract ends.

The following tables provide a reconciliation of the beginning and ending balances for our Level 3 assets and liabilities, which are measured at fair value on a recurring basis using significant unobservable inputs for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Available for sale securities				
Beginning balance	$—	$26	$—	$375
Principal returned	—	(2)	—	(23)
Amortization of premium/accretion of discount	—	(28)	—	(494)
Total gains (losses) (realized/unrealized):				
Included in other comprehensive income (loss)	—	4	—	280
Included in operations	—	—	—	(138)
Ending balance	$—	$—	$—	$—

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Fixed index annuities - embedded derivatives				
Beginning balance	$6,499,015	$5,984,007	$5,983,622	$5,574,653
Premiums less benefits	137,526	207,141	273,287	1,020,853
Change in fair value, net	41,561	(460,031)	421,193	(864,389)
Ending balance	$6,678,102	$5,731,117	$6,678,102	$5,731,117

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

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

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The most sensitive assumption in determining policy liabilities for fixed index annuities is the rates used to discount the excess projected contract values. As indicated above, the discount rate reflects our nonperformance risk. If the discount rates used to discount the excess projected contract values at September 30, 2016, were to increase by 100 basis points, the fair value of the embedded derivatives would decrease by $475.4 million recorded through operations as a decrease in the change in fair value of embedded derivatives and there would be a corresponding decrease of $283.7 million to our combined balance for deferred policy acquisition costs and deferred sales inducements recorded through operations as an increase in amortization of deferred policy acquisition costs and deferred sales inducements. A decrease by 100 basis points in the discount rate used to discount the excess projected contract values would increase the fair value of the embedded derivatives by $532.7 million recorded through operations as an increase in the change in fair value of embedded derivatives and there would be a corresponding increase of $313.5 million to our combined balance for deferred policy acquisition costs and deferred sales inducements recorded through operations as a decrease in amortization of deferred policy acquisition costs and deferred sales inducements.

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3. Investments

At September 30, 2016 and December 31, 2015, the amortized cost and fair value of fixed maturity securities and equity securities were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
September 30, 2016				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$416,503	$1,962	$—	$418,465
United States Government sponsored agencies	1,410,760	62,563	(419)	1,472,904
United States municipalities, states and territories	3,548,586	503,992	(368)	4,052,210
Foreign government obligations	233,825	24,420	(3,825)	254,420
Corporate securities	25,751,501	2,298,306	(134,150)	27,915,657
Residential mortgage backed securities	1,225,720	134,685	(2,231)	1,358,174
Commercial mortgage backed securities	5,121,361	216,346	(27,551)	5,310,156
Other asset backed securities	1,490,821	46,705	(15,102)	1,522,424
	$39,199,077	$3,288,979	$(183,646)	$42,304,410
Held for investment:				
Corporate security	$76,773	$—	$(1,226)	$75,547
Equity securities, available for sale:				
Finance, insurance, and real estate	$7,520	$323	$—	$7,843
December 31, 2015				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$470,567	$988	$(299)	$471,256
United States Government sponsored agencies	1,386,219	26,801	(14,409)	1,398,611
United States municipalities, states and territories	3,422,667	341,328	(8,628)	3,755,367
Foreign government obligations	210,953	12,547	(10,935)	212,565
Corporate securities	23,597,530	887,288	(682,424)	23,802,394
Residential mortgage backed securities	1,366,985	98,576	(3,489)	1,462,072
Commercial mortgage backed securities	4,238,265	41,412	(105,281)	4,174,396
Other asset backed securities	1,130,524	34,534	(19,880)	1,145,178
	$35,823,710	$1,443,474	$(845,345)	$36,421,839
Held for investment:				
Corporate security	$76,622	$—	$(11,245)	$65,377
Equity securities, available for sale:				
Finance, insurance, and real estate	$7,515	$313	$—	$7,828

At September 30, 2016, 36% of our fixed income securities have call features, of which 0.1% ($46.6 million) were subject to call redemption and another 3.4% ($1.3 billion) will become subject to call redemption during the next twelve months. Approximately 69% of our fixed income securities that have call features are not callable until within six months of their stated maturities.

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The amortized cost and fair value of fixed maturity securities at September 30, 2016, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. All of our mortgage and other asset backed securities provide for periodic payments throughout their lives and are shown below as separate lines.

	Available for sale		Held for investment	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
Due in one year or less	$585,813	$591,574	$—	$—
Due after one year through five years	2,449,847	2,626,859	—	—
Due after five years through ten years	11,633,226	12,222,759	—	—
Due after ten years through twenty years	8,770,193	9,756,946	—	—
Due after twenty years	7,922,096	8,915,518	76,773	75,547
	31,361,175	34,113,656	76,773	75,547
Residential mortgage backed securities	1,225,720	1,358,174	—	—
Commercial mortgage backed securities	5,121,361	5,310,156	—	—
Other asset backed securities	1,490,821	1,522,424	—	—
	$39,199,077	$42,304,410	$76,773	$75,547

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

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Net unrealized gains on available for sale fixed maturity securities and equity securities	$3,105,656	$598,442
Adjustments for assumed changes in amortization of deferred policy acquisition costs and deferred sales inducements	(1,657,561)	(322,859)
Deferred income tax valuation allowance reversal	22,534	22,534
Deferred income tax expense	(506,833)	(96,454)
Net unrealized gains reported as accumulated other comprehensive income	$963,796	$201,663

The National Association of Insurance Commissioners (“NAIC”) assigns designations to fixed maturity securities. These designations range from Class 1 (highest quality) to Class 6 (lowest quality). In general, securities are assigned a designation based upon the ratings they are given by the Nationally Recognized Statistical Rating Organizations (“NRSRO’s”). The NAIC designations are utilized by insurers in preparing their annual statutory statements. NAIC Class 1 and 2 designations are considered “investment grade” while NAIC Class 3 through 6 designations are considered “non-investment grade.” Based on the NAIC designations, we had 97% and 98% of our fixed maturity portfolio rated investment grade at September 30, 2016 and December 31, 2015, respectively.

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

	September 30, 2016		December 31, 2015	
NAIC Designation	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
1	$25,136,784	$27,489,043	$23,363,259	$24,207,801
2	12,859,996	13,679,587	11,709,730	11,589,325
3	1,107,948	1,062,620	758,531	643,293
4	147,237	124,317	60,480	44,312
5	12,794	18,839	—	—
6	11,091	5,551	8,332	2,485

$39,275,850	$42,379,957	$35,900,332	$36,487,216

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The following table shows our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities (consisting of 364 and 1,246 securities, respectively) have been in a continuous unrealized loss position, at September 30, 2016 and December 31, 2015:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
September 30, 2016						
Fixed maturity securities:						
Available for sale:						
United States Government sponsored agencies	$76,581	$(419)	$—	$—	$76,581	$(419)
United States municipalities, states and territories	68,084	(368)	—	—	68,084	(368)
Foreign government obligations	—	—	20,750	(3,825)	20,750	(3,825)
Corporate securities:						
Finance, insurance and real estate	453,189	(5,447)	100,261	(5,376)	553,450	(10,823)
Manufacturing, construction and mining	271,769	(5,102)	764,319	(80,318)	1,036,088	(85,420)
Utilities and related sectors	157,473	(3,440)	221,059	(17,989)	378,532	(21,429)
Wholesale/retail trade	16,064	(75)	59,574	(3,914)	75,638	(3,989)
Services, media and other	136,667	(4,545)	133,607	(7,944)	270,274	(12,489)
Residential mortgage backed securities	38,200	(2,144)	1,976	(87)	40,176	(2,231)
Commercial mortgage backed securities	945,680	(27,518)	937	(33)	946,617	(27,551)
Other asset backed securities	263,184	(9,224)	98,048	(5,878)	361,232	(15,102)
	$2,426,891	$(58,282)	$1,400,531	$(125,364)	$3,827,422	$(183,646)
Held for investment:						
Corporate security:						
Insurance	$—	$—	$75,547	$(1,226)	$75,547	$(1,226)
December 31, 2015						
Fixed maturity securities:						
Available for sale:						
United States Government full faith and credit	$37,730	$(299)	$—	$—	$37,730	$(299)
United States Government sponsored agencies	957,053	(14,409)	—	—	957,053	(14,409)
United States municipalities, states and territories	261,823	(8,474)	2,846	(154)	264,669	(8,628)
Foreign government obligations	42,966	(1,762)	15,463	(9,173)	58,429	(10,935)
Corporate securities:						
Finance, insurance and real estate	2,077,223	(59,607)	49,912	(14,855)	2,127,135	(74,462)
Manufacturing, construction and mining	3,517,967	(246,456)	376,229	(131,003)	3,894,196	(377,459)
Utilities and related sectors	2,240,652	(138,940)	97,184	(22,565)	2,337,836	(161,505)
Wholesale/retail trade	473,050	(17,863)	38,682	(8,125)	511,732	(25,988)
Services, media and other	1,037,011	(39,937)	32,050	(3,073)	1,069,061	(43,010)
Residential mortgage backed securities	162,770	(2,958)	6,438	(531)	169,208	(3,489)
Commercial mortgage backed securities	2,679,510	(105,002)	11,495	(279)	2,691,005	(105,281)
Other asset backed securities	457,055	(10,581)	46,657	(9,299)	503,712	(19,880)
	$13,944,810	$(646,288)	$676,956	$(199,057)	$14,621,766	$(845,345)

Held for investment:						
Corporate security:						
Insurance	$65,377	$(11,245)	$—	$—	$65,377	$(11,245)

Based on the results of our process for evaluating available for sale securities in unrealized loss positions for other than temporary impairments, which is discussed in detail later in this footnote, we have determined that the unrealized losses on the securities in the preceding table are temporary. The unrealized losses at September 30, 2016 are principally related to select sectors of the credit markets with spreads that remain wide due to specific market concerns around metals, mining and energy.

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The commodity related sectors had most of the gross unrealized losses in our corporate fixed income securities portfolio as of September 30, 2016 and December 31, 2015. Commodity prices, specifically oil, gas and base metals, declined significantly in late 2015, but prices have risen in 2016 to levels that appear sustainable and should support prices and NRSRO ratings longer term. The value of oil has been significantly depressed as the amount of supply from new production has exceeded demand. In addition, iron ore and other key industrial metals have depressed prices as investors perceive the economic slowdown in Asia Pacific will curb demand as supply remains high. The companies in the metal and mining sectors experienced the largest decline in values of their debt in late 2015. In the above table, oil and metals and mining exposure is reflected within the foreign government; manufacturing, construction and mining; and utilities and related sectors. Within these sectors, we continue to monitor the impact to our investment portfolio for those companies that may be adversely affected, both directly and indirectly. Even though the energy holdings and a majority of the metals and mining holdings have seen significant improvements in values as oil and iron ore prices have increased, they could continue to see price volatility and possible downgrades in credit ratings. If oil and commodity prices fall lower and remain at depressed levels for an extended period of time or decline further, certain issuers and investments may come under further stress. At this time, we believe the unrealized losses are temporary due to the fact that the price decline is driven by an over-supply of oil in the energy sector, which we feel is unsustainable long term. Our exposure is in companies that we believe have more financial flexibility and significant operational scale to manage through the downturn. In addition, price declines in the metal and mining sector have been heavily influenced by excess production and softer demand. Companies in the mining sector are more susceptible to rating downgrades and we believe companies will be under continued financial strain if prices decline again. We believe company issuers in our portfolio will be able to meet their debt service obligations.
Approximately 53% and 84% of the unrealized losses on fixed maturity securities shown in the above table for September 30, 2016 and December 31, 2015, respectively, are on securities that are rated investment grade, defined as being the highest two NAIC designations. All of the fixed maturity securities with unrealized losses are current with respect to the payment of principal and interest.
Changes in net unrealized gains on investments for the three and nine months ended September 30, 2016 and 2015 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Fixed maturity securities held for investment carried at amortized cost	$6,954	$(3,753)	$10,019	$(13,980)
Investments carried at fair value:				
Fixed maturity securities, available for sale	$224,258	$118,345	$2,507,204	$(908,644)
Equity securities, available for sale	28	(30)	10	23
	224,286	118,315	2,507,214	(908,621)
Adjustment for effect on other balance sheet accounts:				
Deferred policy acquisition costs and deferred sales inducements	(115,727)	(60,198)	(1,334,702)	455,011
Deferred income tax asset/liability	(37,995)	(20,341)	(410,379)	158,764
	(153,722)	(80,539)	(1,745,081)	613,775
Change in net unrealized gains on investments carried at fair value	$70,564	$37,776	$762,133	$(294,846)

Proceeds from sales of available for sale securities for the nine months ended September 30, 2016 and 2015 were $364.0 million and $269.7 million, respectively. Scheduled principal repayments, calls and tenders for available for sale securities for the nine months ended September 30, 2016 and 2015 were $1.5 billion and $1.0 billion, respectively.

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Realized gains and losses on sales are determined on the basis of specific identification of investments based on the trade date. Net realized gains (losses) on investments, excluding net OTTI losses for the three and nine months ended September 30, 2016 and 2015, are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Available for sale fixed maturity securities:				
Gross realized gains	$4,956	$283	$11,047	$4,783
Gross realized losses	(79)	(97)	(2,678)	(897)
	4,877	186	8,369	3,886
Other investments:				
Gain on sale of real estate	31	2,245	867	3,278
Loss on sale of real estate	—	—	(93)	(575)
Impairment losses on real estate	—	(570)	—	(1,199)
	31	1,675	774	1,504
Mortgage loans on real estate:				
Decrease (increase) in allowance for credit losses	(113)	(702)	(3,946)	597
Recovery of specific allowance	461	—	5,483	4,375
	348	(702)	1,537	4,972
	$5,256	$1,159	$10,680	$10,362

Losses on available for sale fixed maturity securities were realized primarily due to strategies to reposition the fixed maturity security portfolio that result in improved net investment income, credit risk or duration profiles as they pertain to our asset liability management.

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

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

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

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

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

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

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

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

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

The following table presents the range of significant assumptions used to determine the credit loss component of other than temporary impairments we have recognized on residential mortgage backed securities for the nine months ended September 30, 2016 and 2015, which are all senior level tranches within the structure of the securities:

		Discount Rate		Default Rate		Loss Severity	
Sector	Vintage	Min	Max	Min	Max	Min	Max
Nine months ended September 30, 2016							
Prime	2005	7.7%	7.7%	14%	14%	50%	50%
	2006	7.3%	7.3%	13%	13%	50%	50%
	2007	6.2%	6.4%	18%	31%	50%	55%
Alt-A	2005	7.4%	7.4%	11%	11%	60%	60%
Nine months ended September 30, 2015							
Prime	2006	6.5%	6.5%	14%	14%	40%	40%
	2007	5.8%	7.0%	15%	21%	45%	55%
Alt-A	2005	5.6%	5.6%	99%	99%	2 %	2 %

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

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

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The following table summarizes other than temporary impairments for the three and nine months ended September 30, 2016 and 2015, by asset type:

	Number of Securities	Total OTTI Losses	Portion of OTTI Losses Recognized in (from) Other Comprehensive Income	Net OTTI Losses Recognized in Operations
		(Dollars in thousands)		
Three months ended September 30, 2016				
Fixed maturity securities, available for sale:				
Corporate securities:				
Materials	1	$(4,554)	$ 1,575	$(2,979)
Three months ended September 30, 2015				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	3	$—	$ (354)	$(354)
Other asset backed securities	1	(10,000)	5,125	(4,875)
	4	$(10,000)	$ 4,771	$(5,229)
Nine months ended September 30, 2016				
Fixed maturity securities, available for sale:				
Corporate securities:				
Energy	2	$(642)	$ —	$(642)
Materials	1	(4,554)	1,575	(2,979)
Telecommunications	1	(4,462)	562	(3,900)
Utilities	1	(136)	—	(136)
Residential mortgage backed securities	6	—	(440)	(440)
Commercial mortgage backed securities	5	(1,540)	—	(1,540)
Other asset backed securities	1	—	(3,482)	(3,482)
	17	$(11,334)	$ (1,785)	$(13,119)
Nine months ended September 30, 2015				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	7	$(132)	$ (1,182)	$(1,314)
Other asset backed securities	1	(10,000)	5,125	(4,875)
	8	$(10,132)	$ 3,943	$(6,189)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Cumulative credit loss at beginning of period	$(154,408)	$(128,010)	$(145,824)	$(127,050)
Credit losses on securities for which OTTI has not previously been recognized	(2,979)	(4,876)	(9,197)	(5,008)
Additional credit losses on securities for which OTTI has previously been recognized	—	(353)	(3,922)	(1,181)

Accumulated losses on securities that were disposed of during the period	573	761	2,129	761
Cumulative credit loss at end of period	$(156,814)	$(132,478)	$(156,814)	$(132,478)

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The following table summarizes the cumulative noncredit portion of OTTI and the change in fair value since recognition of OTTI, both of which were recognized in other comprehensive income (loss), by major type of security, for securities that are part of our investment portfolio at September 30, 2016 and December 31, 2015:

	Amortized Cost	OTTI Recognized in Other Comprehensive Income	Change in Fair Value Since OTTI was Recognized	Fair Value
	(Dollars in thousands)			
September 30, 2016				
Fixed maturity securities, available for sale:				
Corporate securities	$12,930	$ (5,112)	$9,729	$17,547
Residential mortgage backed securities	392,598	(170,284)	206,943	429,257
Commercial mortgage backed securities	6,585	—	190	6,775
Other asset backed securities	4,854	(1,643)	(1,566)	1,645
	$416,967	$ (177,039)	$215,296	$455,224
December 31, 2015				
Fixed maturity securities, available for sale:				
Corporate securities	$6,396	$ (2,975)	$9	$3,430
Residential mortgage backed securities	466,871	(170,724)	199,149	495,296
Other asset backed securities	8,154	(5,125)	(553)	2,476
	$481,421	$ (178,824)	$198,605	$501,202

4. Mortgage Loans on Real Estate

Our mortgage loan portfolio is summarized in the following table. There were commitments outstanding of $110.1 million at September 30, 2016.

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Principal outstanding	$2,427,905	$2,449,909
Loan loss allowance	(7,527)	(14,142)
Deferred prepayment fees	(1,148)	(510)
Carrying value	$2,419,230	$2,435,257

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

	September 30, 2016		December 31, 2015	
	Principal	Percent	Principal	Percent
	(Dollars in thousands)			
Geographic distribution				
East	$652,230	26.9 %	$698,113	28.5 %
Middle Atlantic	155,249	6.4 %	160,261	6.6 %
Mountain	231,561	9.5 %	252,442	10.3 %
New England	12,834	0.5 %	13,161	0.5 %
Pacific	387,212	16.0 %	355,268	14.5 %
South Atlantic	474,238	19.5 %	456,227	18.6 %
West North Central	319,341	13.2 %	313,120	12.8 %
West South Central	195,240	8.0 %	201,317	8.2 %
	$2,427,905	100.0%	$2,449,909	100.0%
Property type distribution				
Office	$321,297	13.2 %	$396,154	16.2 %
Medical Office	54,129	2.2 %	77,438	3.2 %
Retail	825,490	34.0 %	790,158	32.2 %
Industrial/Warehouse	677,342	27.9 %	686,400	28.0 %
Hotel	1,142	0.1 %	3,361	0.1 %
Apartment	376,189	15.5 %	352,971	14.4 %
Mixed use/other	172,316	7.1 %	143,427	5.9 %
	$2,427,905	100.0%	$2,449,909	100.0%

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

We evaluate our mortgage loan portfolio for the establishment of a loan loss allowance by specific identification of impaired loans and the measurement of an estimated loss for each individual loan identified. A mortgage loan is impaired when it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. If we determine that the value of any specific mortgage loan is impaired, the carrying amount of the mortgage loan will be reduced to its fair value, based upon the present value of expected future cash flows from the loan discounted at the loan's effective interest rate, or the fair value of the underlying collateral less estimated costs to sell.

In addition, we analyze the mortgage loan portfolio for the need of a general loan allowance for probable losses on all other loans on a quantitative and qualitative basis. The amount of the general loan allowance is based upon management's evaluation of the collectability of the loan portfolio, historical loss experience, delinquencies, credit concentrations, underwriting standards and national and local economic conditions.

We rate each of the mortgage loans in our portfolio based on factors such as historical operating performance, loan to value ratio and economic outlook, among others. We calculate a loss factor to apply to each rating based on historical losses we have recognized in our mortgage loan portfolio. We apply the loss factors to the total principal outstanding within each rating category to determine an appropriate estimate of the general loan loss allowance. We also assess the portfolio qualitatively and apply a loss rate to all loans without a specific allowance based on management's assessment of economic conditions, and we apply an additional amount of loss allowance to a group of loans that we have identified as having higher risk of loss.

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The following table presents a rollforward of our specific and general loss allowances for mortgage loans on real estate:

	Three Months Ended September 30, 2016		Three Months Ended September 30, 2015	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	$(4,552)	$ (6,300)	$(9,316)	$ (7,500)
Charge-offs	2,977	—	—	—
Recoveries	461	—	—	—
Change in provision for credit losses	(213)	100	(1,302)	600
Ending allowance balance	$(1,327)	$ (6,200)	$(10,618)	$ (6,900)

	Nine Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	$(7,842)	$ (6,300)	$(12,333)	$ (10,300)
Charge-offs	5,078	—	143	—
Recoveries	5,483	—	4,375	—
Change in provision for credit losses	(4,046)	100	(2,803)	3,400
Ending allowance balance	$(1,327)	$ (6,200)	$(10,618)	$ (6,900)

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

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Individually evaluated for impairment	$4,683	$ 21,277
Collectively evaluated for impairment	2,423,222	2,428,632
Total loans evaluated for impairment	$2,427,905	$ 2,449,909

Charge-offs include allowances that have been established on loans that were satisfied either by taking ownership of the collateral or by some other means such as discounted pay-off or loan sale. When ownership of the property is taken it is recorded at the lower of the mortgage loan's carrying value or the property's fair value (based on appraised values) less estimated costs to sell. The real estate owned is recorded as a component of other investments and the mortgage loan is recorded as fully paid, with any allowance for credit loss that has been established charged off. Fair value of the real estate is determined by third party appraisal. Recoveries are situations where we have received a payment from the borrower in an amount greater than the carrying value of the loan (principal outstanding less specific allowance).

During the three and nine months ended September 30, 2016 and 2015, no mortgage loans were satisfied by taking ownership of any real estate serving as collateral. The following table summarizes the activity in the real estate owned, included in Other investments, which was obtained in satisfaction of mortgage loans on real estate:

	Three Months Ended September 30,	Nine Months Ended September 30,

	2016	2015	2016	2015
	(Dollars in thousands)			
Real estate owned at beginning of period	$—	$12,958	$6,485	$20,238
Real estate acquired in satisfaction of mortgage loans	—	—	—	—
Additions	—	120	—	120
Sales	—	(2,761)	(6,444)	(9,241)
Impairments	—	(570)	—	(1,199)
Depreciation	—	(53)	(41)	(224)
Real estate owned at end of period	$—	$9,694	$—	$9,694

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

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Credit Exposure--By Payment Activity		
Performing	$2,426,284	$ 2,438,341
In workout	1,621	11,568
Delinquent	—	—
Collateral dependent	—	—
	$2,427,905	$ 2,449,909

The loans that are categorized as "in workout" consist of loans that we have agreed to lower or no mortgage payments for a period of time while the borrowers address cash flow and/or operational issues. The key features of these workouts have been determined on a loan-by-loan basis. Most of these loans are in a period of low cash flow due to tenants vacating their space or tenants requesting rent relief during difficult economic periods. Generally, we have allowed the borrower a six month interest only period and in some cases a twelve month period of interest only. Interest only workout loans are expected to return to their regular debt servic