STEVEN MADDEN, LTD.
Form 10-K
March 12, 2010

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

FORM 10-K

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

For the fiscal year ended December 31, 2009

or

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

For the transition period from to

Commission File Number 0-23702

STEVEN MADDEN, LTD.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	13-3588231 (I.R.S. employer identification no.)

52-16 Barnett Avenue, Long Island City, New York 11104
(Address of principal executive offices) (Zip Code)

(718) 446-1800
(Registrant's Telephone Number, Including Area Code)
Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value $.0001 per share	The NASDAQ Stock Market LLC
Preferred Stock Purchase Rights	The NASDAQ Stock Market LLC

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Act.
Yes o No x

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 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 website, 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 o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 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.

Large accelerated filer o	Accelerated filer x	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

The aggregate market value of the common equity held by non-affiliates of the registrant (assuming for these purposes, but without conceding, that all executive officers and directors are "affiliates" of the registrant) as of June 30, 2009, the last business day of the registrant's most recently completed second fiscal quarter, was approximately $385,532,000 (based on the closing sale price of the registrant's common stock on that date as reported on The NASDAQ Global Select Market).

The number of outstanding shares of the registrant's common stock as of March 9, 2010 was 18,348,786 shares.

DOCUMENTS INCORPORATED BY REFERENCE:

PART III INCORPORATES CERTAIN INFORMATION BY REFERENCE FROM THE REGISTRANT'S DEFINITIVE PROXY STATEMENT FOR THE REGISTRANT'S 2010 ANNUAL MEETING OF STOCKHOLDERS.

TABLE OF CONTENTS

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements as that term is defined in the federal securities laws that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, which include statements with regard to future revenue, projected 2010 results, earnings, spending, margins, cash flow, orders, expected timing of shipment of products, inventory levels, future growth or success in specific countries, categories or market sectors, continued or expected distribution to specific retailers, liquidity, capital resources and market risk, strategies and objectives and other future events. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or simply state future results, performance or achievements, and can be identified by the use of forward looking language such as “believe,” “anticipate,” “expect,” “estimate,” “intend,” “plan,” “p
“will be,” “will continue,” “will result,” “could,” “may,” “might,” or any variations of such words with similar meanings. Fa
that may affect our results include, but are not limited to, the risks and uncertainties discussed in Item 1A of this Annual Report on Form 10-K.

Any such statements are subject to risks and uncertainties, many of which are beyond our control, that may influence the accuracy of the statements and the projections upon which the statements are based that could cause actual results to differ materially from those projected in forward-looking statements. As such, we caution you that these statements are not guarantees of future performance or events. Our actual results, performance and achievements could differ materially from those expressed or implied in these forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether from new information, future events or otherwise.

PART I

ITEM 1 BUSINESS

Steven Madden, Ltd. and its subsidiaries (collectively, the “Company”) design, source, market and sell fashion-forward footwear for women, men and children. In addition, we design, source, market and sell name brand and private label fashion handbags and accessories through our Accessories Division. We distribute products through our retail stores, our e-commerce website, department and specialty stores throughout the United States and through special distribution arrangements in Asia, Canada, Europe, Central and South America, Australia and Africa. Our product line includes a broad range of updated styles designed to establish or capitalize on market trends, complemented by core products. We have established a reputation for our creative designs, popular styles and quality products at affordable price points.

Fiscal year 2009 was a record year for Steven Madden, Ltd. Consolidated net sales for 2009 increased to a record $503.6 million from $457.0 million during 2008. Our gross margin increased in fiscal year 2009 to 42.9%, 200 basis points greater than the 40.9% achieved in 2008. Net income increased 79% in 2009 to a record $50.1 million from $28.0 million in 2008. Diluted earnings per share for the year ended December 31, 2009 increased 81% to a record $2.73 per share on 18,323,000 diluted weighted average shares outstanding compared to $1.51 per share on 18,519,000 diluted weighted average shares outstanding in 2008. Net cash provided by operating activities increased to a record $64.3 million in 2009 compared to $41.8 million in 2008.

We have expanded our accessories portfolio through two recent acquisitions. In July, 2009, we acquired certain assets constituting the Zone 88 and Shakedown Street (together “Zone 88”) lines of SML Brands, LLC, a subsidiary of Aimee Lynn, Inc, which designs and markets primarily private label accessories, principally handbags, for mass merchants and mid-tier retailers. The acquisition was completed for $1.3 million in cash. We believe this acquisition will enable us to expand our accessories business in the private label arena with value priced customers.

Most recently, subsequent to our year end, on February 10, 2010, the Company acquired all of the outstanding shares of stock of Big Buddha, Inc. (“Big Buddha”) from its sole stockholder, Jeremy Bassan. Founded in 2003, Big Buddha designs and markets fashion-forward handbags to specialty retailers and better department stores. The acquisition was completed for $11.0 million in cash plus potential earn out payments based on annual financial performance of Big Buddha through March 31, 2013.

1

On September 2, 2009, the Company expanded its brand portfolio by entering into an additional license agreement with Dualstar Entertainment Group, LLC, under which the Company has the right to use the Olsenboye® trademark in connection with the sale and marketing of footwear and accessories exclusively to J.C. Penney. The agreement requires the Company to make royalty and advertising payments equal to a percentage of net sales and a minimum royalty and advertising payment in the event that specified net sales targets are not achieved. The agreement expires on December 31, 2011, but is renewable, at our option, for one three-year term, if certain conditions are met.

In addition, we made progress on our stated goal to evolve Steve Madden® into a global lifestyle brand by entering into two new license agreements. On October 20, 2009, we signed a license agreement to license our Steve Madden® trademark for the design, manufacture and worldwide distribution of women's fashion apparel. On January 7, 2010, we signed a license agreement to license our Steve Madden® and Steven by Steve Madden® trademarks for the design, manufacture and worldwide distribution of women's fashion jewelry. The new fashion apparel and jewelry lines, which will initially ship in the spring and fall of 2010, respectively, join our existing licenses for cold weather accessories, sunglasses, eyewear, outerwear, bedding and hosiery offerings. Management is pleased to be expanding the Company's presence beyond footwear and accessories and believes the new apparel and jewelry lines mark very logical extensions of the Company's brands.

Steven Madden, Ltd. was incorporated as a New York corporation on July 9, 1990 and reincorporated under the same name in Delaware in November 1998. We completed our initial public offering in December 1993 and our shares of common stock, $.0001 par value per share, currently trade on the NASDAQ Global Select Market under the symbol "SHOO".

We maintain our principal executive offices at 52-16 Barnett Avenue, Long Island City, NY 11104 and our telephone number is (718) 446-1800.

Our website is http://www.stevemadden.com. We file Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other reports and information with the Securities and Exchange Commission (the "SEC") pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). We make these reports, any amendments to such reports, and our proxy statements for our stockholders' meetings available free of charge, on our website as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. We will provide paper copies of such filings free of charge upon request. The public may read and copy any materials filed by us with the SEC at the SEC's Public Reference Room at 100 R Street, NE, Washington, D.C. 20549. The public may also obtain information on the operation of the SEC's Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding us, which is available at http://www.sec.gov.

Product Distribution Segments

Our business is comprised of five distinct segments (Wholesale Footwear, Wholesale Accessories, Retail, First Cost and Licensing). Our Wholesale Footwear segment includes seven core divisions: Steve Madden Women's, Steve Madden Men's, Madden Girl, Steven, Stevies, Elizabeth and James and our international business. Our Wholesale Accessories segment, through license agreements, includes Betsey Johnson®, Daisy Fuentes® and Olsenboye® accessories brands. Steven Madden Retail, Inc., our wholly owned retail subsidiary, operates Steve Madden and Steven retail stores as well as our e-commerce website. There are also three stores licensed to a third party. The First Cost segment represents activities of a subsidiary which earns commissions for serving as a buying agent for footwear products under private labels and licensed brands (such as l.e.i.®, Candie's® and Olsenboye®) for many of the country's large mass-market merchandisers, shoe chains and other off-price retailers. In the Licensing segment, the Company licenses its Steve Madden® and Steven by Steve Madden® trademarks for use in connection with the manufacturing, marketing and sale of cold weather accessories, sunglasses, eyewear, outerwear, bedding, hosiery, women's fashion apparel and jewelry.

2

Wholesale Footwear Segment

Steve Madden Women's Division. The Steve Madden Women's Division ("Madden Women's") designs, sources and markets our Steve Madden brand to major department stores, mid-tier department stores, better specialty stores and independently owned boutiques throughout the United States. The Steve Madden brand has become a leading life-style brand in the fashion conscious marketplace. To serve our customers (primarily women ages 16 to 35), Madden Women's creates and markets fashion forward footwear designed to appeal to customers seeking exciting, new footwear designs at affordable prices.

As our largest division, Madden Women's generated net sales of $148.0 million for the year ended December 31, 2009, or approximately 29% of our total net sales. New products for Madden Women's are test marketed at our retail stores. Typically, within a few days, we can determine if the test product appeals to our customers. This enables us to use our flexible sourcing model to rapidly respond to changing trends, which we believe is essential for success in the fashion arena.

Madden Girl Division. The Madden Girl Division ("Madden Girl") designs, sources and markets a full collection of directional young women's shoes. Madden Girl is geared for young women ages 13 to 20 and is an "opening price point" brand that is currently sold at major department stores, mid-tier retailers and specialty stores. Madden Girl generated net sales of $62.5 million for the year ended December 31, 2009, or approximately 12% of our total net sales.

Steve Madden Men's Division. The Steve Madden Men's Division ("Madden Men's") designs, sources and markets a full collection of directional men's shoes and fashion forward athletic shoes to major department stores, mid-tier department stores, better specialty stores and independent shoe stores throughout the United States. Price points range from $70 to $100 at retail, targeted at men ages 20 to 40 years old. Madden Men's generated net sales of $40.0 million for the year ended December 31, 2009, or approximately 8% of our total net sales. Madden Men's maintains open stock inventory positions in select patterns to serve the replenishment programs of its wholesale customers.

Steven Division. The Steven Division designs, sources and markets women's fashion footwear under the Steven® trademark through major department and better footwear specialty stores throughout the United States. Priced a tier above the Steve Madden brand, Steven products are designed to appeal principally to fashion conscious women, ages 25 to 45, who shop at department stores and footwear boutiques. The Steven Division generated net sales of $23.6 million for the year ended December 31, 2009, or approximately 5% of our total net sales.

International Division. Prior to 2009, our international business (the "International Division") operated under the "first cost" model and, thus, the revenues derived from our international business were included in Commissions and Licensing Fees in the Consolidated Statements of Income of our Financial Statements. In order to improve operating efficiencies, and to give our international partners better visibility in the process, as of January 2009, we have changed the operating model for our international business to the "wholesale" model. Our International Division ships products to China, Canada, Mexico, the United Kingdom, Israel, UAE, Turkey, Australia, Korea, Morocco, and several countries in southeast Asia, Europe and Central and South America. Our International Division generated net sales of $22.1 million for the year ended December 31, 2009 or 4% of our total net sales.

Elizabeth and James Division. On September 10, 2008, we entered into a license agreement with Dualstar Entertainment Group, LLC, under which we have the right to use the Elizabeth and James trademark in connection with the sale and marketing of footwear. The Elizabeth and James brand, which was created by Mary-Kate and Ashley Olsen, is distributed through luxury retailers to women ages 25 to 36 years with average retail price points from $200 to $350 for shoes and from $350 to $500 for boots. Our Elizabeth and James Division, which began shipping in April 2009, generated net sales of $4.3 million for the year ended December 31, 2009 or 1% of our total net sales.

Steve Madden Kids Division. Our Steve Madden Kids Division (“Madden Kids”) designs, sources and markets footwear for young girls to department stores, specialty stores and independent boutiques throughout the United States. Madden Kids generated net sales of $7.3 million for the year ended December 31, 2009, or approximately 1% of our total net sales.

Wholesale Accessories Segment

Our Wholesale Accessories segment designs, sources and markets name brand (including Betsey Johnson®, Daisy Fuentes® and Olsenboye® in addition to our Steve Madden® and Steven by Steve Madden® brands) and private label fashion handbags and accessories to major department stores, mid-tier department stores, value price retailers and independent stores throughout the United States. The Wholesale Accessories segment generated net sales of $70.4 million for the year ended December 31, 2009, or approximately 14% of our total net sales.

Retail Segment

Steven Madden Retail, Inc. As of December 31, 2009, the Company, through our wholly owned subsidiary Steven Madden Retail, Inc., owned and operated 89 retail stores including 84 stores under the Steve Madden name, four under the Steven name and our e-commerce website (at www.stevemadden.com). In 2009, we opened two new stores, closed seven underperforming stores and licensed out three stores. Steve Madden stores are located in major shopping malls and in urban street locations across the United States, primarily focused in New York, California and Florida. In 2009, our retail stores generated annual sales in excess of $640 per square foot. Comparative store sales (sales of those stores, including the e-commerce website, that were open for all of 2009 and 2008) increased 1% in fiscal year 2009 compared to fiscal year 2008. The Retail segment generated net sales of $123.7 million for the year ended December 31, 2009, or approximately 25% of our total net sales.

We believe that the Retail segment will continue to enhance overall sales and profitability while increasing recognition for the Steve Madden brand. We plan to open one to three new retail stores and close six to nine underperforming stores during 2010. Our retail stores enable us to test and react to new products and classifications which, in turn, strengthens the product development efforts of the Steve Madden Wholesale segments.

First Cost Segment

The First Cost segment represents activities of a subsidiary which earns commissions for serving as a buying agent for footwear products under private labels and licensed brands (such as l.e.i.®, Candie’s® and Olsenboye®) for many of the country’s large mass-market merchandisers, shoe chains and other mid-tier retailers. As a buying agent, we utilize our expertise and our relationships with shoe manufacturers to facilitate the production of private label shoes to our customers’ specifications. We believe that by operating in the private label, mass merchandising market, we are able to maximize additional non-branded sales opportunities. This leverages our overall sourcing and design capabilities. Currently, this segment serves as a buying agent for the procurement of women’s, men’s and children’s footwear for large retailers, including Target, Wal-Mart, Kohl’s, J.C. Penney and Sears. The First Cost segment receives buying agent’s commissions from its customers. In addition, we have leveraged the strength of our Steve Madden brands and product designs resulting in a partial recovery of our design, product and development costs from our suppliers. The First Cost segment generated operating income of $16.8 million for the year ended December 31, 2009.

Licensing Segment

We license our Steve Madden® and Steven by Steve Madden® trademarks for use in connection with the manufacturing, marketing and sale of cold weather accessories, sunglasses, eyewear, outerwear, bedding, hosiery, women’s fashion apparel and jewelry. Most of our license agreements require the licensee to pay us a royalty based on actual net sales, a minimum royalty in the event that specified net sales targets are not achieved and a percentage of sales for advertising the brand. Licensing income for the year ended December 31, 2009 was $3.1 million.

See Note N to our Consolidated Financial Statements for additional information relating to our five operating segments.

4

Product Design and Development

We have established a reputation for our creative designs, marketing and trendy products at affordable price points. We believe that our future success will substantially depend on our ability to continue to anticipate and react to changing consumer demands in a timely manner. To meet this objective, we have developed an unparalleled design process that allows us to recognize and act quickly to changing consumer demands. Our design team strives to create designs which it believes fit our image, reflect current or future trends and can be manufactured in a timely and cost-effective manner. Once the initial design is complete, a prototype is developed, primarily in our Long Island City facility, which is reviewed and refined prior to the commencement of initial production. Most new products are then tested in selected Steve Madden retail stores. Based on these tests, among other things, management selects the products that are then offered for wholesale and retail distribution nationwide. We believe that our design and testing process and flexible sourcing model is a significant competitive advantage allowing us to mitigate the risk of production costs and the distribution of less desirable designs.

Product Sourcing and Distribution

We source each of our product lines separately based on the individual design, style and quality specifications of the products in such product lines. We do not own or operate manufacturing facilities; rather, we source our products through agents and our own sourcing office with independently owned manufacturers in China, Mexico, Brazil, Italy, Spain and India. We have established relationships with a number of manufacturers and agents in each of these countries. Although we have not entered into any long-term manufacturing or supply contracts, we believe that a sufficient number of alternative sources exist for the manufacture of our products. We continually monitor the availability of the principal materials used in our footwear, which are available from a number of sources in various parts of the world. We track inventory flow on a regular basis, monitor sell-through data and incorporate input on product demand from wholesale customers. We use retailers' feedback to adjust the production or manufacture of new products on a timely basis, which helps reduce the close out of slow-moving products.

We distribute our products from three third-party distribution warehouse centers located in California and New Jersey. By utilizing distribution facilities that specialize in distributing products to certain wholesale accounts, Steve Madden retail stores and Internet fulfillment, we believe that our customers are better served.

Customers

Our wholesale customers consist principally of department stores and specialty stores, including independent boutiques. Approximately 69% of our wholesale revenue is generated from department and specialty stores, including Macy's, DSW, Nordstrom, Famous Footwear, Dillard's and Lord & Taylor as well as mid-tier department stores and catalog retailers, including Victoria's Secret. For the year ended December 31, 2009, DSW accounted for approximately $52.9 million, or 14% of our wholesale net sales and 11% of our total net sales. Macy's accounted for approximately $39.0 million, or 10% of our wholesale net sales and 8% of our total net sales in 2009.

Distribution Channels

United States

We sell our products principally through department stores, specialty stores and discount stores and through our company-owned retail stores. For the year ended December 31, 2009, our Retail segment and our Wholesale segment generated net sales of approximately $123.7 million and $379.8 million, or 25% and 75% of our total net sales, respectively. Each of these distribution channels are described below.

Steve Madden and Steven Retail Stores. As of December 31, 2009, we operated 84 company-owned retail stores under the Steve Madden name and four under the Steven name and our e-commerce website (at www.stevemadden.com). We believe that our retail stores will continue to enhance overall sales, profitability, and our ability to react to changing consumer trends. The stores are also a marketing tool that allows us to strengthen brand recognition and to showcase selected items from our full line of branded and licensed products. Furthermore, the retail stores provide us with a venue to test and introduce new products and merchandising strategies. Specifically, we often test new designs at our Steve Madden retail stores before scheduling them for mass production and wholesale distribution. In addition to these test marketing benefits, we have been able to leverage sales information gathered at Steve Madden retail stores to assist our wholesale customers in order placement and inventory management.

A typical Steve Madden store is approximately 1,400 to 1,600 square feet and is located in a mall or street location that we expect will attract the highest concentration of our core demographic, style-conscious customer base. The Steven stores, which are generally the same size as our Steve Madden stores, have a more sophisticated design and format styled to appeal to their more mature target audience. In addition to carefully analyzing mall demographics and locations, we set profitability guidelines for each potential store site. Specifically, we target well trafficked sites at which the demographics fit our consumer profile and seek new locations where the projected fixed annual rent expense stays within our guidelines. By setting these guidelines, we seek to identify stores that will contribute to our overall profitability both in the near and longer terms.

Department Stores. We currently sell to over 1,900 doors of 17 department stores throughout the United States. Our major accounts include Macy’s, Nordstrom, Dillard’s and Lord & Taylor.

We provide merchandising support to our department store customers which includes in-store fixtures and signage, supervision of displays and merchandising of our various product lines. Our wholesale merchandising effort includes the creation of in-store concept shops, where a broader collection of our branded products are showcased. These in-store concept shops create an environment that is consistent with our image and are designed to enable the retailer to display and sell a greater volume of our products per square foot of retail space. In addition, these in-store concept shops encourage longer term commitment by the retailer to our products and enhance consumer brand awareness.

In addition to merchandising support, our key account executives maintain weekly communications with their respective accounts to guide them in placing orders and to assist them in managing inventory, assortment and retail sales. We leverage our sell-through data gathered at our retail stores to assist department stores in allocating their open-to-buy dollars to the most popular styles in the product line and to phase out styles with weaker sell-throughs, which reduces markdown exposure at season’s end.

Specialty Stores/Catalog Sales. We currently sell to specialty store locations throughout the United States. Our major specialty store accounts include DSW, Famous Footwear and Journeys. We offer our specialty store accounts the same merchandising, sell-through and inventory tracking support offered to our department store accounts. Sales of our products are also made through various catalogs, such as Victoria’s Secret.

Internet Sales. We operate an Internet website, www.stevemadden.com, where customers can purchase numerous styles of our Madden Women’s, Steven and Madden Men’s as well as selected styles of Madden Girl, footwear and accessory products.

International

Our products are available in many countries and territories worldwide via several retail selling and distribution agreements. Under the terms of the various agreements, the distributors and retailers are generally required to open a minimum number of stores each year and to pay us a fee for each pair of footwear purchased, and in many cases, an additional sales royalty as a percentage of sales or a predetermined amount per unit of sale. Distributors are required to purchase a specified minimum number of products within specified periods. The agreements we have in place expire at various times through December 31, 2014 and include renewal options. These agreements are exclusive in their specific territories, which include China, Canada, Mexico, the United Kingdom, Israel, UAE, Turkey, Australia, Korea, Morocco, and several countries in Southeast Asia, Europe and Central and South America.

Competition

The fashion industry is highly competitive. We compete with specialty shoe and accessory companies as well as companies with diversified footwear product lines, such as Nine West, Skechers, Kenneth Cole, Nike, Guess and Jessica Simpson. Our competitors may have greater financial and other resources than us. We believe effective advertising and marketing, fashionable styling, high quality, value and fast manufacturing turnaround are the most important competitive factors and intend to continue to employ these elements as we develop our products. However, we cannot be certain that we will be able to compete successfully against our current and future competitors, or that competitive pressures will not have a material adverse effect on our business, financial condition and results of operations.

Marketing and Sales

We have focused on creating an integrated brand building program to establish Steve Madden as a leading designer of fashion footwear for style-conscious young women and men. Principal marketing activities include product placements in lifestyle and fashion magazines, personal appearances by our founder and Creative and Design Chief, Steve Madden, and in-store promotions. In addition, we continue to promote our e-commerce website (www.stevemadden.com) where customers can purchase products under the brands Steve Madden, Steven, Steve Madden Men’s and selected styles from Madden Girl footwear, as well as view exclusive content, participate in contests and “live chat” with customer service representatives.

Management Information Systems (MIS) Operations

Sophisticated information systems are essential to our ability to maintain our competitive position and to support continued growth. We operate on a dual AS/400 system which provides system support for all aspects of our business, including manufacturing purchase orders, customer purchase orders, order allocations, invoicing, accounts receivable management, quick response replenishment, point-of-sale support and financial and management reporting functions. We have a PKMS bar coded warehousing system that is integrated with the wholesale system in order to provide accurate inventory positions and quick response size replenishment for our customers. In addition, we have installed an EDI system which provides a computer link between us and certain wholesale customers that enables both the customer and us to monitor purchases, shipments and invoicing. The EDI system also improves our ability to respond to customer inventory requirements on a weekly basis.

Intellectual Property

Trademarks

We own numerous trademarks including Steve Madden®, Steve Madden plus Design®, Steven by Steve Madden® and various PEACE LOVE SHOES designs. As of December 31, 2009, we have 216 U.S. and internationally registered trademarks or trademark applications pending in the trademark offices of 67 countries around the world including the U.S. From time to time we adopt new trademarks in connection with the marketing of new product lines. We believe that our trademarks have significant value and are important to the marketing of our products, identifying the Company and distinguishing our products from the products of others. We consider our Steve Madden→, Steve Madden plus Design®, Steven by Steve Madden® and the various PEACE LOVE SHOES design marks to be among our most valuable assets and have registered these marks in numerous countries and in numerous International Classes. We act aggressively to register and vigorously to protect our trademarks against infringement. There can be no assurance, however, that we will be able to effectively obtain rights to our marks throughout all of the countries of the world. Moreover, no assurance can be given that others will not assert rights in or ownership of, our marks and other proprietary rights or that we will be able to resolve any such conflicts successfully. Our failure to protect such rights from unlawful and improper appropriation may have a material adverse effect on our business, financial condition, results of operations and liquidity.

Trademark Licensing

We believe that expanding the Company's presence beyond footwear and accessories is a logical extension of the Company's brands. Therefore, on October 20, 2009, we licensed our Steve Madden® mark for the design, manufacture and worldwide distribution of women's fashion apparel and, on January 7, 2010, we licensed our Steve Madden® and Steven by Steve Madden® marks for the design, manufacture and worldwide distribution of women's fashion jewelry. The new fashion apparel and jewelry lines, which will initially ship in the spring and fall of 2010, respectively, join our existing licenses for cold weather accessories, sunglasses, eyewear, outerwear, bedding and hosiery offerings. Our licensees pay us a royalty and, in substantially all of our license agreements, an advertising fee equal to a percentage of net sales and a minimum royalty and advertising fee in the event that specified net sales targets are not achieved. See Note A[13] to our Consolidated Financial Statements included in this Annual Report on Form 10-K for additional disclosure regarding these licensing arrangements.

In addition to out-licenses of our trademarks, we also license from third parties certain marks used in connection with certain of our product lines. We have a license from Betsey Johnson LLC providing the right to use the Betsey Johnson® and Betseyville® trademarks in connection with the sale and marketing of handbags, small leather goods, belts and umbrellas. In addition, we have licenses from Dualstar Entertainment Group, LLC under which the Company has the right to use the Olsenboye® trademark in connection with the sale and marketing of footwear and accessories and the Elizabeth and James® trademark in connection with the sale and marketing of footwear. We also hold a license from Phat Fashions LLC to design, manufacture and distribute women's footwear, handbags and belts and related accessories under the Fabulosity® brand and a license from Jones Investment Co. Inc. to use the l.e.i.® trademark in connection with the marketing and sale of women's footwear exclusively to Wal-Mart. We also hold a license from Dafu Licensing, Inc. to design, manufacture and distribute handbags and belts and related accessories under the DF Daisy Fuentes® and the Daisy Fuentes® brands. We also hold a license from IP Holdings LLC to sell Candie's® banded footwear to Kohl's. Substantially all of these licensing agreements require us to make royalty and advertising payments to the licensor equal to a percentage of our net sales and a minimum royalty and advertising payment in the event that specified net sales targets are not achieved.

See Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note L[4] to our Consolidated Financial Statements included in this Annual Report on Form 10-K for additional information relating to each of the above referenced licensing arrangements.

Employees

On February 5, 2010, we employed approximately 1,370 employees, of whom approximately 700 work on a full-time basis and approximately 670 work on a part-time basis, most of whom work in the Retail segment. All of our employees are located in the United States with the exception of approximately 30 employees located in Hong Kong and China who perform quality control and administrative duties. None of our employees are represented by a union. Our management considers relations with our employees to be good. The Company has never experienced a material interruption of its operations due to a labor dispute.

Seasonality

Historically, our merchandising businesses have experienced holiday retail seasonality. In addition to seasonal fluctuations, our operating results fluctuate quarter to quarter as a result of the timing of holidays, weather, the timing of larger shipments of footwear, market acceptance of our products, product mix, pricing and presentation of the products offered and sold, the hiring and training of additional personnel, inventory write downs for obsolescence, the cost of materials, the product mix between wholesale, retail and licensing businesses, the incurrence of other operating costs and factors beyond our control, such as general economic conditions and actions of competitors.

Backlog

We had unfilled wholesale customer orders of $151.7 million and $90.5 million, as of February 21, 2010 and 2009, respectively. Our backlog at a particular time is affected by a number of factors, including seasonality, timing of market weeks and wholesale customer purchases of our core basic products through our open stock program. Accordingly, a comparison of backlog from period to period may not be indicative of eventual shipments.

ITEM 1A RISK FACTORS

You should carefully consider the risks and uncertainties we describe below and the other information in this Annual Report on Form 10-K before deciding to invest in, sell or retain shares of our common stock. These are not the only risks and uncertainties that we face. Additional risks and uncertainties that we do not currently know about or that we currently believe are immaterial, or that we have not predicted, may also harm our business operations or adversely affect us. If any of these risks or uncertainties actually occurs, our business, financial condition, results of operations and liquidity could be materially harmed.

Fashion Industry Risks. Our success depends in significant part upon our ability to anticipate and respond to product and fashion trends as well as to anticipate, gauge and react to changing consumer demands in a timely manner. There can be no assurance that our products will correspond to the changes in taste and demand or that we will be able to successfully market products that respond to such trends. If we misjudge the market for our products, we may be faced with significant excess inventories for some products and missed opportunities for others. In addition, misjudgments in merchandise selection could adversely affect our image with our customers resulting in lower sales and increased markdown allowances for customers which could have a material adverse effect on our business, financial condition, results of operations and liquidity.

The industry in which we operate is cyclical, with purchases tending to decline during recessionary periods when disposable income is low. Purchases of contemporary shoes and accessories tend to decline during recessionary periods and also may decline at other times. There can be no assurance that we will be able to grow or even maintain our current level of revenues and earnings, or remain profitable in the future. A recession in the national or regional economies or uncertainties regarding future economic prospects, among other things, could affect consumer spending habits. The recent volatility and disruption of global economic and financial market conditions has led to declines in consumer confidence and spending in the United States and internationally. Further deterioration or a continued weakness of economic and financial market conditions for an extended period of time could have a material adverse effect on our business, financial condition, results of operations and liquidity.

In recent years, the retail industry has experienced consolidation and other ownership changes. In the future, retailers in the United States and in foreign markets may further consolidate, undergo restructurings or reorganizations, or realign their affiliations, any of which could decrease the number of stores that carry our products or increase the ownership concentration within the retail industry. While such changes in the retail industry to date have not had a material adverse effect on our business or financial condition, results of operations and liquidity, there can be no assurance as to the future effect of any such changes.

Economic Uncertainty and Political Risks. Our opportunities for long-term growth and profitability are accompanied by significant challenges and risks, particularly in the near term. Specifically, our business is dependent on consumer demand for our products. We believe that declining consumer confidence accompanied with changes in credit availability, interest rates, energy prices, unemployment rates and consumers' disposable income negatively impacted the level of consumer spending for discretionary items during the years ended December 31, 2008 and 2009. Despite the worsening retail environment, in 2009 we achieved a substantial revenue growth in the Wholesale segment that was partially offset by a small decrease in revenues in the Retail segment. A continued weak economic environment could have a negative effect on the Company's sales and results of operations during the year ending December 31, 2010 and thereafter. In addition, unstable political conditions in some parts of the world, including potential or actual international conflicts, or the continuation or escalation of terrorism, could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Inventory Management. The fashion-oriented nature of our products and the rapid changes in customer preferences leave us vulnerable to an increased risk of inventory obsolescence. Thus, our ability to manage our inventories properly is an important factor in our operations. Inventory shortages can adversely affect the timing of shipments to customers and diminish sales and brand loyalty. Conversely, excess inventories can result in lower gross margins due to the excessive discounts and markdowns that might be necessary to reduce inventory levels. Our inability to effectively manage our inventory could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Dependence upon Customers and Risks Related to Extending Credit to Customers. Our customers consist principally of major department stores, mid-tier department stores, better specialty stores and independently-owned boutiques. Certain of our department store customers, including some under common ownership, account for significant portions of our wholesale business.

We generally enter into a number of purchase order commitments with our customers for each of our lines every season and do not enter into long-term agreements with any of our customers. Therefore, a decision by a significant customer, whether motivated by competitive conditions, financial difficulties or otherwise, to decrease the amount of merchandise purchased from us or to change its manner of doing business could have a material adverse effect on our business, financial condition, results of operations and liquidity.

We sell our products primarily to retail stores across the United States and extend credit based on an evaluation of each customer's financial condition, usually without collateral. While various retailers, including some of our customers, have experienced financial difficulties in the past few years which increased the risk of extending credit to such retailers, our losses due to bad debts have been limited. Pursuant to the terms of our factoring agreement, our factor, Rosenthal & Rosenthal, Inc., currently assumes the credit risk related to approximately 83% of our accounts receivable. However, financial difficulties of a customer could cause us to curtail business with such customer or require us to assume more credit risk relating to such customer's accounts receivable.

Impact of Foreign Manufacturers; Custom Duties. Virtually all of our products are purchased through arrangements with a number of foreign manufacturers, primarily from China, Mexico, Brazil, Italy, Spain and India.

Risks inherent in foreign operations include work stoppages, transportation delays and interruptions, changes in social, political and economic conditions which could result in the disruption of trade from the countries in which our manufacturers or suppliers are located, the imposition of additional regulations relating to imports, the imposition of additional duties, taxes and other charges on imports, significant fluctuations of the value of the dollar against foreign currencies, or restrictions on the transfer of funds, any of which could have a material adverse effect on our business, financial condition, results of operations and liquidity. We do not believe that any such economic or political condition will materially affect our ability to purchase products, since a variety of materials and alternative sources are available. However, we cannot be certain that we will be able to identify such alternative sources without delay, if at all, or without greater cost to us. Our inability to identify and secure alternative sources of supply in this situation could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Our imported products are also subject to United States custom duties. The United States and the countries in which our products are produced or sold, from time to time, impose new quotas, duties, tariffs, or other restrictions, or may adversely adjust prevailing quota, duty or tariff levels, any of which could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Possible Adverse Impact of Manufacturers' Inability to Manufacture in a Timely Manner, Meet Quality Standards or to Use Acceptable Labor Practices. As is common in the footwear industry, we contract for the manufacture of virtually all of our products to our specifications through foreign manufacturers. We do not own or operate any manufacturing facilities and, therefore, we are dependent upon third parties for the manufacture of all of our products. The inability of a manufacturer to ship orders of our products in a timely manner or to meet our quality standards could cause us to miss the delivery date requirements of our customers for those items, which could result in cancellation of orders, refusal to accept deliveries or a reduction in purchase prices, any of which could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Although we enter into a number of purchase order commitments each season specifying a time frame for delivery, method of payment, design and quality specifications and other standard industry provisions, we do not have long-term contracts with any manufacturer. As a consequence, any of these manufacturing relationships may be terminated, by either party, at any time. Although we believe that other facilities are available for the manufacture of our products, there can be no assurance that such facilities would be available to us on an immediate basis, if at all, or that the costs charged to us by such manufacturers would not be greater than those presently paid.

We do not control our licensing partners or independent manufacturers or their labor practices. The violation of labor or other laws by an independent manufacturer of ours or by one of our licensing partners, or the divergence of a manufacturer's or a licensing partner's labor practices from those generally accepted as ethical in the United States, could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Intense Industry Competition. The fashion footwear industry is highly competitive and barriers to entry are low. Our competitors include specialty companies as well as companies with diversified product lines. The recent market growth in the sales of fashion footwear has encouraged the entry of many new competitors and increased competition from established companies. Most of these competitors, including Nine West, Skechers, Kenneth Cole, Nike, Guess and Jessica Simpson may have significantly greater financial and other resources than we do and there can be no assurance that we will be able to compete successfully with other fashion footwear companies. Increased competition could result in pricing pressures, increased marketing expenditures and loss of market share, and could have a material adverse effect on our business, financial condition, results of operations and liquidity. We believe effective advertising and marketing, branding of the Steve Madden® trademark, fashionable styling, high quality and value are the most important competitive factors and we plan to continue to employ these elements as we develop our products. Our inability to effectively advertise and market our products could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Expansion of Retail Business. Our continued growth depends to a significant degree on further developing the Steve Madden, Stevies, Steven, Madden Girl, Steve Madden Men's, Steve Madden Fix, Candies, Elizabeth and James, Olsenboye and l.e.i. brands, creating new product categories and businesses and operating company-owned Steve Madden and Steven stores on a profitable basis. During the year ended December 31, 2009, we opened two, closed seven and licensed out three Steve Madden retail stores and have plans to open one to three and close six to nine stores in the year ending December 31, 2010. We also remodeled seven existing stores. Our future expansion plan includes the opening of stores in new geographic markets as well as strengthening existing markets. New markets have in the past presented, and will continue to present, competitive and merchandising challenges that are different from those faced by us in our existing markets. There can be no assurance that we will be able to open new stores, and if opened, that such new stores will be able to achieve sales and profitability levels consistent with management's expectations. Our retail expansion is dependent on a number of factors, including our ability to locate and obtain favorable store sites, the performance of our wholesale and retail operations, and our ability to manage such expansion and hire and train personnel. Past comparable store sales results may not be indicative of future results, and there can be no assurance that our comparable store sales results can be maintained or will increase in the future. In addition, there can be no assurance that our strategies to increase other sources of revenue, which may include expansion of our licensing activities, will be successful or that our overall sales or profitability will increase or not be adversely affected as a result of the implementation of such retail strategies.

Management of Growth. Our operations have increased and will continue to increase demand on our managerial, operational and administrative resources. We have recently invested significant resources in, among other things, our management information systems and hiring and training new personnel. However, in order to manage currently anticipated levels of future demand, we may be required to, among other things, expand our distribution facilities, establish relationships with new manufacturers to produce our product, and continue to expand and improve our financial, management and operating systems. There can be no assurance that we will be able to manage future growth effectively and a failure to do so could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Seasonal and Quarterly Fluctuations. Our results may fluctuate quarter to quarter as a result of the timing of holidays, weather, the timing of larger shipments of footwear, market acceptance of our products, the mix, pricing and presentation of the products offered and sold, the hiring and training of additional personnel, inventory write downs for obsolescence, the cost of materials, the product mix between wholesale, retail and licensing businesses, the incurrence of other operating costs and factors beyond our control, such as general economic conditions and actions of competitors. In addition, we expect that our sales and operating results may be significantly impacted by the opening of new retail stores and the introduction of new products. Accordingly, the results of operations in any quarter will not necessarily be indicative of the results that may be achieved for a full fiscal year or any future quarter.

Trademark Protection. We believe that our trademarks and other proprietary rights are important to our success and our competitive position. Accordingly, we devote substantial resources to the establishment and protection of our marks on a worldwide basis. Nevertheless, there can be no assurance that the actions taken by us to establish and protect our marks and other proprietary rights will be adequate to prevent imitation of our products by others or to prevent others from seeking to block sales of our products on the basis that our products violate the trademarks and proprietary rights of others. Moreover, no assurance can be given that others will not assert rights in, or ownership of, trademarks and other proprietary rights of ours or that we will be able to successfully resolve such conflicts. In addition, the laws of certain foreign countries may not protect proprietary rights to the same extent as do the laws of the United States. Our failure to establish and then protect such proprietary rights from unlawful and improper utilization could have a material adverse effect on our business, financial condition, results of operations and liquidity.

Foreign Currency Fluctuations. We make approximately 99% of our purchases in U.S. dollars. However, we source substantially all of our products overseas and, as such, the cost of these products may be affected by changes in the value of the relevant currencies. Changes in currency exchange rates may also affect the relative prices at which we and our foreign competitors sell products in the same market. There can be no assurance that foreign currency fluctuations will not have a material adverse effect on our business, financial condition, results of operations and liquidity.

Dependence on Key Personnel. The future of our business depends to a significant degree on the skills and efforts of our Creative and Design Chief, Steven Madden, and our senior executives. If we lose the services of our Creative and Design Chief or any of our senior executives, and especially if any of our executives joins a competitor or forms a competing company, our business and financial performance could be seriously harmed. A loss of our Creative and Design Chief's or any of our executive officers' skills, knowledge of the industry, contacts and expertise could cause a setback to our operating plan and strategy.

Outstanding Options. As of March 9, 2010, there were outstanding options to purchase an aggregate of approximately 1,076,000 shares of our common stock. Holders of such options are likely to exercise them when the market price of our stock is significantly higher than the exercise price of the options. Further, while options are outstanding, they may adversely affect the terms on which we could obtain additional capital, if required.

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

ITEM 2 PROPERTIES

We lease approximately 41,900 square feet for our corporate headquarters and sample production facilities at 52-16 Barnett Avenue, Long Island City, NY 11104 pursuant to a lease which expires on June 30, 2013. The Steve Madden showroom is located at 1370 Avenue of the Americas, New York, NY. All of our brands are displayed for sale from this 9,917 square foot space. The lease for our showroom expires on February 28, 2013.

We lease approximately 20,000 square feet for our Accessories Division's offices and showroom space at 10 West 33rd Street, New York, NY. The lease expires on December 31, 2014.

We lease approximately 6,500 square feet for our Madden Zone Division's office space at 17-19 West 34th Street, New York, NY. The initial term of the lease expires on April 30, 2010 with an option, at our election, to extend it on a month-to-month basis that can be terminated by either party with 30 days' prior written notice.

We maintain approximately 7,200 square feet as a storage facility at 25-15 Borough Place, Woodside, NY. The lease for this space expires on October 31, 2013.

We own a building that is approximately 2,200 square feet that is located across the street from our executive offices at 38-35 Woodside Avenue, Long Island City, NY 11104.

We lease approximately 3,600 square feet for office space in Kwai Chung, Hong Kong. This lease will expire on March 4, 2011.

In addition, we lease approximately 4,825 square feet for office space in Kuangdong Province, China. This lease will expire on January 31, 2013.

All of our retail stores are leased pursuant to leases that, under their original terms, extend for an average of ten years. A majority of the leases include clauses that provide for contingent rental payments if gross sales exceed certain targets and, as such, a majority of the leases enable us and/or the landlord to terminate the lease in the event that our gross sales do not achieve certain minimum levels during a prescribed period. Many of the leases contain rent escalation clauses to compensate for increases in operating costs and real estate taxes. The current terms of our retail store leases, including our three licensed stores and two unoccupied locations, expire as follows:

Years Lease Terms Expire	Number of Stores
2010	12
2011	14
2012	8
2013	13
2014	5
2015	5
2016	6
2017	14
2018	10
2019	6
2020	1

ITEM 3 LEGAL PROCEEDINGS

On June 24, 2009, The Center For Environmental Health filed a lawsuit, Center for Environmental Health v. Lulu NYC, LLC, Steve Madden, Ltd., Steve Madden Retail, Inc., et al., Case No. RG09459448, in California Superior Court, Alameda County, against the Company and dozens of other California retailers and vendors of leather, vinyl, and/or imitation leather handbags, belts, and shoes alleging that the retailers and vendors failed to warn that certain of such products may expose California citizens to lead and lead compounds. The parties have been in negotiations to resolve the matters informally and have finalized the substance of a consent judgment, the terms of which are not material to the Company’s Consolidated Financial Statements.

On June 24, 2009, a class action lawsuit Shahrzad Tahvilian, et al. v. Steve Madden Retail, Inc. and Steve Madden, Ltd., Case No. BC 414217, was filed in the Superior Court of California, Los Angeles County, against the Company and its wholly-owned subsidiary, Steven Madden Retail, Inc.. The complaint, which seeks unspecified damages, alleges violations of California labor laws, including, among other things, that the Company failed to provide mandated meal breaks to its employees and failed to provide overtime pay as required. The Company filed an answer in the litigation denying all allegations stated in the complaint. The parties have agreed to submit the claim to private mediation, which is scheduled for March 29, 2010. The Company, with the advice of legal counsel, has evaluated the liability in this case and believes that it is not likely to exceed $1 million. Accordingly, the Company accrued $1 million in the fiscal year 2009. The accrual is subject to change to reflect the status of this matter.

On August 10, 2005, following the conclusion of an audit of the Company conducted by auditors of U.S. Customs and Border Protection ("U.S. Customs") during 2004 and 2005, U.S. Customs issued a report that asserts that certain commissions that the Company treated as "buying agents' commissions" (which are non-dutiable) should be treated as "selling agents' commissions" and hence are dutiable. In September of 2007, U.S. Customs notified the Company that it had finalized its assessment of the underpaid duties to be $1.4 million. On October 20, 2005, U.S. Immigration and Customs Enforcement notified the Company's legal counsel that a formal investigation of the Company's importing practices had been commenced as a result of the audit. The Company has contested the conclusions of the U.S. Customs audit and filed a request for review and issuance of rulings thereon by U.S. Customs Headquarters, Office of Regulations and Rulings, under internal advice procedures. On November 28, 2007, U.S. Customs Headquarters informed the Company that its request for internal advice had been accepted and was under review. All efforts by U.S. Customs to collect additional duties, fees, interest or penalties have been stayed pending final decision of U.S. Customs Headquarters. In the event that the U.S. Customs auditors' position is ultimately upheld, the Company may be subject to monetary penalties. A final determination of the matter may not occur for several months or even years. The Company, with the advice of legal counsel, has evaluated the Company's potential liability in this matter, including additional duties, interest and penalties, and believes that it is not likely to exceed $2.7 million. Therefore, as of December 31, 2007, the Company had recorded a total reserve of $2.7 million that was increased by $256 thousand in 2008 and $89 thousand in 2009 to reflect anticipated additional interest costs, bringing the reserve to $3 million as of December 31, 2009. Such reserve is subject to change to reflect the status of this matter.

We have been named as a defendant in certain other lawsuits in the normal course of business. In the opinion of management, after consulting with legal counsel, the liabilities, if any, resulting from these matters should not have a material effect on our financial position or results of operations.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the holders of our common stock during the last quarter of our fiscal year ended December 31, 2009.

PART II

ITEM 5 MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information. Our shares of common stock have traded on the NASDAQ Global Select Market since August 1, 2007 and were traded on the NASDAQ National Market prior to that date. The following table sets forth the range of high and low closing sales prices for our common stock during each fiscal quarter during the two-year period ended December 31, 2009 as reported by the NASDAQ Global Select. The trading volume of our securities fluctuates and may be limited during certain periods. As a result, the liquidity of an investment in our securities may be adversely affected.

Common Stock

	High	Low		High	Low
2009			2008		
Quarter ended March 31, 2009	$ 22.80	$ 13.57	Quarter ended March 31, 2008	$ 19.52	$ 14.98
Quarter ended June 30, 2009	$ 30.15	$ 19.04	Quarter ended June 30, 2008	$ 22.74	$ 16.05
Quarter ended September 30, 2009	$ 37.25	$ 23.87	Quarter ended September 30, 2008	$ 28.36	$ 18.13

Quarter ended December 31, 2009	$ 42.91	$ 35.68	Quarter ended December 31, 2008	$ 24.60	$ 14.20

Holders. As of March 9, 2010, there were 18,348,786 shares of common stock outstanding and 76 holders of record.

Dividends. With the exception of a special cash dividend paid in November 2005 and in November 2006, we have not declared or paid any cash dividends in the past to the holders of our common stock and do not currently anticipate declaring or paying any cash dividends in the foreseeable future. We intend to retain earnings, if any, to finance the development and expansion of our business. Future dividend policy will be subject to the discretion of our Board of Directors and will be contingent upon future earnings, if any, our financial condition, capital requirements, general business conditions, and other factors. Therefore, we can give no assurance that any cash dividends of any kind will be paid to holders of our common stock in the future.

Equity Compensation Plans. Information regarding our equity compensation plans as of December 31, 2009 is disclosed in Item 12, “Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.”

Issuer Repurchases of Equity Securities. We did not repurchase any shares of our common stock during the fourth quarter of fiscal 2009. In February and August of 2007, our Board of Directors authorized increases of our previously announced share repurchase program of $30 million and $37 million, respectively. At December 31, 2009, an aggregate of $2 million remained authorized to repurchase our common stock. The program has no set expiration date.

Performance Graph. The following graph compares the yearly percentage change in the cumulative total stockholder return on our common stock during the period beginning on December 31, 2004, and ending on December 31, 2009, with the cumulative total return on the Russell 2000 Index and the S&P 500 Footwear Index. The comparison assumes that $100 was invested on December 31, 2004 in our common stock and in the foregoing indices and assumes the reinvestment of dividends.

	12/31/2004	12/31/2005	12/31/2006	12/31/2007	12/31/2008	12/31/2009
Steven Madden, Ltd.	$100.00	$154.98	$279.08	$159.07	$169.57	$328.00
Russell 2000 Index	$100.00	$103.32	$120.89	$117.57	$76.65	$95.98
S&P 500 Footwear Index	$100.00	$99.42	$114.97	$149.17	$118.42	$153.42

ITEMSELECTED FINANCIAL DATA
6

The following selected financial data has been derived from our audited Consolidated Financial Statements. The Income Statement Data relating to 2009, 2008 and 2007, and the Balance Sheet data as of December 31, 2009 and 2008 should be read in conjunction with the information provided in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the notes to our Consolidated Financial Statements appearing elsewhere in this Annual Report on Form 10-K.

INCOME STATEMENT DATA
Year Ended December 31,
(in thousands, except per share data)

	2009	2008	2007	2006	2005
Net sales	$ 503,550	$ 457,046	$ 431,050	$ 475,163	$ 375,786
Cost of sales	287,361	270,222	257,646	276,734	236,631
Gross profit	216,189	186,824	173,404	198,429	139,155
Commissions and licensing fee income - net	19,928	14,294	18,351	14,246	7,119
Operating expenses	(157,149)	(156,212)	(138,841)	(134,377)	(114,185)
Impairment of goodwill	—	—	—	—	(519)
Income from operations	78,968	44,906	52,914	78,298	31,570
Interest income	2,096	2,620	3,876	3,703	2,554
Interest expense	(93)	(207)	(65)	(100)	(164)
Loss on sale of marketable securities	(182)	(1,013)	(589)	(967)	(500)
Income before provision for income taxes	80,789	46,306	56,136	80,934	33,460
Provision for income taxes	30,682	18,330	20,446	34,684	14,260
Net Income	$ 50,107	$ 27,976	$ 35,690	$ 46,250	$ 19,200
Basic income per share	$ 2.78	$ 1.53	$ 1.73	$ 2.21	$ 0.95
Diluted income per share	$ 2.73	$ 1.51	$ 1.68	$ 2.09	$ 0.92
Basic weighted average shares of common stock	18,045	18,325	20,647	20,906	20,112
Effect of potential shares of common stock from exercise of options	278	194	645	1,195	806
Diluted weighted average shares of common stock	18,323	18,519	21,292	22,101	20,918

outstanding					
Dividends paid per share of common stock	$ 0.00	$ 0.00	$ 0.00	$ 1.00	$ 0.67

BALANCE SHEET DATA
At December 31,

	2009	2008	2007	2006	2005
Total assets	$ 326,859	$ 284,693	$ 266,521	$ 251,392	$ 211,728
Working capital	139,007	122,086	121,138	151,711	114,066
Noncurrent liabilities	6,710	5,801	3,470	3,136	2,757
Stockholders’ equity	$ 267,787	$ 206,242	$ 215,334	$ 211,924	$ 182,065

ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our Financial Condition and Results of Operations should be read in conjunction with our audited Consolidated Financial Statements and notes thereto appearing elsewhere in this Annual Report on Form 10-K.

Overview
($ in thousands, except retail sales data per square foot and earnings per share data)

Steven Madden, Ltd. and its subsidiaries (collectively the "Company") design, source, market and sell fashion-forward footwear for women, men and children. In addition, we design, source, market and sell name brand and private label fashion handbags and accessories, through our Accessories Division. We distribute products through department and specialty stores, our retail stores and our e-commerce website throughout the United States and through special distribution arrangements in Asia, Canada, Europe, Central and South America, Australia and Africa. Our product line includes a broad range of updated styles which are designed to establish or capitalize on market trends, complemented by core products. We have established a reputation for our creative designs, popular styles and quality products at accessible price points.

Our business is comprised of five distinct segments (Wholesale Footwear, Wholesale Accessories, Retail, First Cost and Licensing). Our Wholesale Footwear segment includes seven core divisions: Steve Madden Women's, Steve Madden Men's, Madden Girl, Steven, Steve Madden Kids, Elizabeth and James and our international business. Our Wholesale Accessories segment, through license agreements, includes Betsey Johnson®, Daisy Fuentes® and Olsenboye® accessories brands. Steven Madden Retail, Inc., our wholly owned retail subsidiary, operates Steve Madden and Steven retail stores as well as our e-commerce website. The First Cost segment represents activities of a subsidiary which earns commissions for serving as a buying agent for footwear products under private labels and licensed brands (such as l.e.i.®, Candie's® and Olsenboye®) for many of the country's large mass-market merchandisers, shoe chains and other off-price retailers. In the Licensing segment, the Company licenses its Steve Madden® and Steven by Steve Madden® trademarks for use in connection with the manufacturing, marketing and sale of cold weather accessories, sunglasses, eyewear, outerwear, bedding, hosiery, women's fashion apparel and jewelry.

Prior to 2009, our international business operated under the "first cost" model and, thus, the revenues derived from our international business were included in Commissions and Licensing Fees in the Consolidated Statements of Income. In order to improve operating efficiencies, and to give our international partners better visibility in the process, as of January of 2009, we have changed the operating model for our international business to the "wholesale" model. Under the "wholesale" model, we will be able to manage inventory levels, improve delivery times, and increase our ability to receive payments on a timely basis. As a result of this change, commencing with the first quarter of 2009, international revenues are now included in the Net Sales line in the Consolidated Statements of Income. For the year ended December 31, 2009, our international business contributed net sales of $22,055, or 4% of our total net sales.

Net sales for the year ended December 31, 2009 also reflect shifts related to our Candie's® business, which we distribute exclusively to Kohl's. Pursuant to an agreement with Kohl's, Candie's® has been transitioned from a wholesale model to a "first cost" model and, therefore, revenues for 2009 are included in Commissions and Licensing Fees in the Consolidated Statements of Income. As a result of this change, net sales for 2009 does not reflect Candies revenue while net sales for 2008 reflected revenue of $14,308 for the Candie's® business.

Fiscal year 2009 was a record year for Steven Madden, Ltd. Consolidated net sales for 2009 increased to a record $503,550 from $457,046 during 2008. Our gross margin increased in the year ended December 31, 2009 to 42.9%, 200 basis points greater than the 40.9% achieved in 2008. Net income increased 79% to a record $50,107 in 2009 from $27,976 in 2008. Diluted earnings per share for the year ended December 31, 2009 increased 81% to a record $2.73 per share on 18,323,000 diluted weighted average shares outstanding compared to $1.51 per share on 18,519,000 diluted weighted average shares outstanding in 2008. Net cash provided by operating activities increased to a record $64,342 in 2009 compared to $41,779 in 2008.

We have expanded our accessories portfolio through two recent acquisitions. On July 8, 2009, we acquired certain assets constituting the Zone 88 and Shakedown Street (together "Zone 88") lines of SML Brands, LLC, a subsidiary of Aimee Lynn, Inc, which designs and markets primarily private label accessories, principally handbags, for mass merchants and mid-tier retailers. The acquisition was completed for $1,348 in cash. We believe this acquisition will enable us to expand our accessories business in the private label arena with value priced customers. Subsequent to our year-end, on February 10, 2010, the Company acquired all of the outstanding shares of stock of Big Buddha, Inc. ("Big Buddha") from its sole stockholder, Jeremy Bassan. Founded in 2003, Big Buddha designs and markets fashion-forward handbags to specialty retailers, better department stores and online retailers. The acquisition was completed for $11,000 in cash plus potential earn out payments to Mr. Bassan based on financial performance of Big Buddha through March 31, 2013.

In September 2009, the Company expanded its brand portfolio by entering into a license agreement with Dualstar Entertainment Group, LLC, under which the Company has the right to use the Olsenboye® trademark in connection with the sale and marketing of footwear and accessories exclusively to J.C. Penney. The agreement requires the Company to make royalty and advertising payments equal to a percentage of net sales and a minimum royalty and advertising payment in the event that specified net sales targets are not achieved. The agreement expires on December 31, 2011, but is renewable, at our option, for one three-year term, if certain conditions are met.

In addition, we made progress on our stated goal to evolve Steve Madden into a global lifestyle brand by entering into two new license agreements. On October 20, 2009, we signed a license agreement to license our Steve Madden® trademark for the design, manufacture and worldwide distribution of women's fashion apparel. On January 7, 2010, we signed a license agreement to license our Steve Madden® and Steven by Steve Madden® trademarks for the design, manufacture and worldwide distribution of women's fashion jewelry. The new fashion apparel and jewelry lines, which will initially ship in the spring and fall of 2010, respectively, join our existing licenses for cold weather accessories, sunglasses, eyewear, outerwear, bedding and hosiery offerings. Management is pleased to be expanding the Company's presence beyond footwear and accessories and believes the new apparel and jewelry lines mark a very logical extension of the Company's brands.

In our Retail segment, same store sales (sales of those stores, including the e-commerce website, that were in operation throughout 2009 and 2008) increased 1% in 2009. As of December 31, 2009, we had 89 stores in operation, compared to 97 stores as of December 31, 2008. During the year ended December 31, 2009, sales per square foot increased to $640 compared to sales per square foot of $628 achieved in 2008.

As of December 31, 2009, our total inventory decreased to $30,453 from $31,597 as of December 31, 2008, and our annualized inventory turnover improved to 9.8 times in 2009 compared to 8.1 times in 2008. Our accounts receivable average collection days improved to 54 days in 2009 compared to 55 days in 2008. As of December 31, 2009, we had $154,950 in cash, cash equivalents and marketable securities, no short- or long-term debt, and total stockholders' equity of $267,787.

The following tables set forth information on operations for the periods indicated:

Years Ended
December 31
($ in thousands)

	2009		2008		2007	
CONSOLIDATED:						
Net sales	$ 503,550	100 %	$ 457,046	100 %	$ 431,050	100 %
Cost of sales	287,361	57	270,222	59	257,646	60
Gross profit	216,189	43	186,824	41	173,404	40
Other operating income – net of expenses	19,928	4	14,294	3	18,351	4
Operating expenses	157,149	31	156,212	34	138,841	32
Income from operations	78,968	16	44,906	10	52,914	12
Interest and other income – net	1,821	—	1,400	—	3,222	1
Income before income taxes	80,789	16	46,306	10	56,136	13
Net income	50,107	10	27,976	6	29,583,753	—

Residential mortgage backed securities	1,102,609	—	1,102,609	—
Commercial mortgage backed securities	5,596,882	—	5,596,882	—
Other asset backed securities	3,617,514	—	3,617,514	—
Other investments: equity securities	157,431	150,000	7,431	—
Derivative instruments	847,741	—	847,741	—
Cash and cash equivalents	723,784	723,784	—	—
Interest rate caps	890	—	890	—
Interest rate swap	427	—	427	—
Counterparty collateral	124,778	—	124,778	—
	$ 47,406,399	$ 879,700	$ 46,526,699	$ —
Liabilities				
Fixed index annuities - embedded derivatives	$ 8,233,557	$ —	$ —	$ 8,233,557
	$ 8,233,557	$ —	$ —	$ 8,233,557
December 31, 2017				
Assets				
Fixed maturity securities:				
Available for sale:				
United States Government full faith	$ 11,876	$ 5,640	$ 6,236	$ —

and credit				
United States Government sponsored agencies	1,305,017	—	1,305,017	—
United States municipalities, states and territories	4,166,812	—	4,166,812	—
Foreign government obligations	239,360	—	239,360	—
Corporate securities	29,878,971	5	29,878,966	—
Residential mortgage backed securities	1,105,567	—	1,105,567	—
Commercial mortgage backed securities	5,544,850	—	5,544,850	—
Other asset backed securities	3,120,536	—	3,120,536	—
Other investments: equity securities, available for sale	292,429	285,000	7,429	—
Derivative instruments	1,568,380	—	1,568,380	—
Cash and cash equivalents	1,434,045	1,434,045	—	—
Interest rate caps	415	—	415	—
Counterparty collateral	186,108	—	186,108	—
	$ 48,854,366	$ 1,724,690	$ 47,129,676	$ —
Liabilities				
Interest rate swap	$ 789	$ —	$ 789	$ —
Fixed index annuities - embedded derivatives	8,790,427	—	—	8,790,427
	$ 8,791,216	$ —	$ 789	$ 8,790,427

11

Table of Contents

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 quotes or prices from additional parties as needed. 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 March 31, 2018 and December 31, 2017.

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 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); 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

Equity securities are the only financial instruments included in other investments that are measured at fair value on a recurring basis (see determination of fair value above). Financial instruments included in other investments that are not measured at fair value on a recurring basis 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 values and the fair values afforded these instruments are immaterial to our consolidated financial position and, accordingly, the cost to provide such disclosure does not justify the benefit to be derived. The fair values of our equity method investments are obtained from third parties and determined by calculating the present value of future cash flows discounted by a risk free rate, a risk spread and a liquidity discount. As the risk spread and liquidity discount are unobservable market inputs, the fair value of our equity method investments falls within Level 3 of the fair value hierarchy. The fair value of our COLI approximates the cash surrender value of the policies and falls within Level 2 of the fair value hierarchy.

Table of Contents

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 a projected London Interbank Offered Rate ("LIBOR") for the term of the swap and caps.
Counterparty collateral
Amounts reported in other assets 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.
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 issued immediate annuity contracts. We are not required to and have not estimated the fair value of the liabilities under contracts that involve significant mortality or morbidity risks, as these liabilities fall within the definition of insurance contracts that are exceptions from financial instruments that require disclosures of fair value. Policy benefit reserves, coinsurance deposits and SPIA benefit reserves are not measured at fair value on a recurring basis. All of the fair values presented within these categories fall within Level 3 of the fair value hierarchy as most of the inputs are unobservable market data.
Notes payable
The fair values of our senior unsecured notes are based upon pricing matrices developed by a third party pricing service when quoted market prices are not available and are categorized as Level 2 within the fair value hierarchy. Notes payable are not remeasured at fair value on a recurring basis.
Subordinated debentures
Fair values for subordinated debentures are estimated using discounted cash flow calculations based principally on observable inputs including our incremental borrowing rates, which reflect our credit rating, for similar types of borrowings with maturities consistent with those remaining for the debt being valued. These fair values are categorized as Level 2 within the fair value hierarchy. Subordinated debentures are not measured at fair value on a recurring basis.
Amounts due under repurchase agreements
The amounts reported in the consolidated balance sheets for short term indebtedness under repurchase agreements with variable interest rates approximate their fair values.
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 March 31, 2018

and December 31, 2017, we utilized an estimate of 3.10% for the expected cost of annual call options, which is based on estimated long-term account value growth and a historical review of our actual option costs.

Table of Contents

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)	March 31, 2018	December 31, 2017	March 31, 2018	December 31, 2017
1 - 5	2.11%	1.83%	3.33%	3.32%
6 - 10	7.30%	7.01%	3.33%	3.32%
11 - 15	11.33%	11.31%	3.34%	3.34%
16 - 20	11.91%	11.96%	3.24%	3.20%
20+	11.58%	11.62%	3.21%	3.20%

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 table provides a reconciliation of the beginning and ending balances for our Level 3 liabilities, which are measured at fair value on a recurring basis using significant unobservable inputs for the three months ended March 31, 2018 and 2017:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Fixed index annuities - embedded derivatives		
Beginning balance	$8,790,427	$6,563,288
Premiums less benefits	549,153	411,502
Change in fair value, net	(1,106,023)	76,210
Ending balance	$8,233,557	$7,051,000

The fair value of our fixed index annuities embedded derivatives is net of coinsurance ceded of $529.6 million and $539.7 million as of March 31, 2018 and December 31, 2017, respectively. Change in fair value, net for each period in our embedded derivatives is included in change in fair value of embedded derivatives in the unaudited consolidated statements of operations.

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

The most sensitive assumption in determining policy liabilities for fixed index annuities is the rates used to discount the excess projected contract values. As indicated above, the discount rate reflects our nonperformance risk. If the discount rates used to discount the excess projected contract values at March 31, 2018, were to increase by 100 basis points, the fair value of the embedded derivatives would decrease by $529.0 million recorded through operations as a decrease in the change in fair value of embedded derivatives and there would be a corresponding decrease of $321.0 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 $588.5 million recorded through operations as an increase in the change in fair value of embedded derivatives and there would be a corresponding increase of $340.9 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.

Table of Contents

3. Investments

At March 31, 2018 and December 31, 2017, the amortized cost and fair value of fixed maturity securities were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
March 31, 2018				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$11,696	$110	$(373)	$11,433
United States Government sponsored agencies	1,308,312	21,134	(59,340)	1,270,106
United States municipalities, states and territories	3,853,098	296,762	(12,855)	4,137,005
Foreign government obligations	227,617	8,502	(4,448)	231,671
Corporate securities	28,801,351	1,186,607	(403,830)	29,584,128
Residential mortgage backed securities	1,044,032	65,581	(7,004)	1,102,609
Commercial mortgage backed securities	5,685,290	33,098	(121,506)	5,596,882
Other asset backed securities	3,579,417	52,730	(14,633)	3,617,514
	$44,510,813	$1,664,524	$(623,989)	$45,551,348
Held for investment:				
Corporate security	$77,043	$—	$(7,602)	$69,441
December 31, 2017				
Fixed maturity securities:				
Available for sale:				
United States Government full faith and credit	$11,861	$162	$(147)	$11,876
United States Government sponsored agencies	1,308,290	28,457	(31,730)	1,305,017
United States municipalities, states and territories	3,804,360	366,048	(3,596)	4,166,812
Foreign government obligations	228,214	13,171	(2,025)	239,360
Corporate securities	28,127,653	1,897,005	(145,687)	29,878,971
Residential mortgage backed securities	1,028,484	79,554	(2,471)	1,105,567
Commercial mortgage backed securities	5,531,922	82,768	(69,840)	5,544,850
Other asset backed securities	3,075,975	57,966	(13,405)	3,120,536
	$43,116,759	$2,525,131	$(268,901)	$45,372,989
Held for investment:				
Corporate security	$77,041	$—	$(581)	$76,460
Other investments: equity securities, available for sale:				
Finance, insurance, and real estate	$292,429	$—	$—	$292,429

At March 31, 2018, 37% of our fixed income securities have call features, of which 2.7% ($1.2 billion) were subject to call redemption and another 0.2% ($111.2 million) will become subject to call redemption during the next twelve months. Approximately 74% of our fixed income securities that have call features are not callable until within six months of their stated maturities.

Table of Contents

The amortized cost and fair value of fixed maturity securities at March 31, 2018, 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	$218,825	$223,487	$—	$—
Due after one year through five years	5,615,360	5,673,765	—	—
Due after five years through ten years	10,439,109	10,428,466	—	—
Due after ten years through twenty years	9,188,746	9,774,966	—	—
Due after twenty years	8,740,034	9,133,659	77,043	69,441
	34,202,074	35,234,343	77,043	69,441
Residential mortgage backed securities	1,044,032	1,102,609	—	—
Commercial mortgage backed securities	5,685,290	5,596,882	—	—
Other asset backed securities	3,579,417	3,617,514	—	—
	$44,510,813	$45,551,348	$77,043	$69,441

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

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Net unrealized gains on available for sale fixed maturity securities	$1,040,535	$2,256,230
Adjustments for assumed changes in amortization of deferred policy acquisition costs and deferred sales inducements	(562,755)	(1,206,078)
Deferred income tax valuation allowance reversal	22,534	22,534
Deferred income tax expense (a)	(100,332)	(348,087)
Net unrealized gains reported as accumulated other comprehensive income	$399,982	$724,599

(a) December 31, 2017 includes $128 million related to the impact of Tax Reform that was reclassified between accumulated other comprehensive income and retained earnings within our consolidated balance sheet during the first quarter of 2018. For more information regarding the reclassification, see Note 1 to our unaudited consolidated financial statements.

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% of our fixed maturity portfolio rated investment grade at both March 31, 2018 and December 31, 2017, respectively.

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

	March 31, 2018		December 31, 2017	
NAIC Designation	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
1	$27,142,276	$27,984,297	$26,669,427	$28,274,379
2	15,897,296	16,147,267	15,198,551	15,869,219

3	1,350,395	1,316,146	1,161,737	1,157,420
4	170,754	145,085	134,838	117,542
5	17,108	19,926	17,015	20,927
6	10,027	8,068	12,232	9,962
	$44,587,856	$45,620,789	$43,193,800	$45,449,449

16

Table of Contents

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 1,902 and 955 securities, respectively) have been in a continuous unrealized loss position, at March 31, 2018 and December 31, 2017:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
March 31, 2018						
Fixed maturity securities:						
Available for sale:						
United States Government full faith and credit	$3,193	$(50)	$6,380	$(323)	$9,573	$(373)
United States Government sponsored agencies	74,632	(1,513)	932,691	(57,827)	1,007,323	(59,340)
United States municipalities, states and territories	224,928	(5,000)	124,097	(7,855)	349,025	(12,855)
Foreign government obligations	127,620	(2,442)	12,297	(2,006)	139,917	(4,448)
Corporate securities:						
Finance, insurance and real estate	1,980,979	(46,008)	599,683	(48,915)	2,580,662	(94,923)
Manufacturing, construction and mining	1,378,585	(29,518)	229,805	(17,840)	1,608,390	(47,358)
Utilities and related sectors	1,830,012	(41,549)	239,209	(18,121)	2,069,221	(59,670)
Wholesale/retail trade	755,307	(16,446)	173,229	(16,809)	928,536	(33,255)
Services, media and other	3,498,221	(85,932)	855,680	(82,692)	4,353,901	(168,624)
Residential mortgage backed securities	286,561	(4,535)	24,870	(2,469)	311,431	(7,004)
Commercial mortgage backed securities	2,495,283	(43,167)	1,310,142	(78,339)	3,805,425	(121,506)
Other asset backed securities	797,174	(6,376)	187,857	(8,257)	985,031	(14,633)
	$13,452,495	$(282,536)	$4,695,940	$(341,453)	$18,148,435	$(623,989)
Held for investment:						
Corporate security:						
Insurance	$—	$—	$69,441	$(7,602)	$69,441	$(7,602)
December 31, 2017						
Fixed maturity securities:						
Available for sale:						
United States Government full faith and credit	$1,565	$(10)	$6,731	$(137)	$8,296	$(147)
United States Government sponsored agencies	44,794	(180)	958,965	(31,550)	1,003,759	(31,730)
United States municipalities, states and territories	44,736	(128)	128,499	(3,468)	173,235	(3,596)
Foreign government obligations	49,663	(337)	12,625	(1,688)	62,288	(2,025)
Corporate securities:						
Finance, insurance and real estate	456,244	(5,135)	600,655	(28,043)	1,056,899	(33,178)
Manufacturing, construction and mining	222,985	(3,475)	231,196	(10,849)	454,181	(14,324)
Utilities and related sectors	395,183	(4,099)	249,416	(8,901)	644,599	(13,000)
Wholesale/retail trade	152,941	(1,249)	178,635	(11,371)	331,576	(12,620)
Services, media and other	729,124	(19,000)	891,654	(53,565)	1,620,778	(72,565)
Residential mortgage backed securities	39,771	(387)	32,917	(2,084)	72,688	(2,471)
Commercial mortgage backed securities	1,096,757	(10,385)	1,306,437	(59,455)	2,403,194	(69,840)

Other asset backed securities	765,531	(3,499)	217,595	(9,906)	983,126	(13,405)
	$3,999,294	$(47,884)	$4,815,325	$(221,017)	$8,814,619	$(268,901)
Held for investment:						
Corporate security:						
Insurance	$—	$—	$76,460	$(581)	$76,460	$(581)

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 March 31, 2018 are principally related to timing of the purchases of these securities, which carry less yield than those available at March 31, 2018.

17

Table of Contents

Approximately 88% and 83% of the unrealized losses on fixed maturity securities shown in the above table for March 31, 2018 and December 31, 2017, 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 months ended March 31, 2018 and 2017 are as follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Fixed maturity securities held for investment carried at amortized cost	$(7,021)	$(1,976)
Investments carried at fair value:		
Fixed maturity securities, available for sale	$(1,215,695)	$281,094
Equity securities, available for sale	—	(13)
	(1,215,695)	281,081
Adjustment for effect on other balance sheet accounts:		
Deferred policy acquisition costs and deferred sales inducements	643,323	(150,962)
Deferred income tax asset/liability	120,201	(45,542)
	763,524	(196,504)
Change in net unrealized gains on investments carried at fair value	$(452,171)	$84,577

Proceeds from sales of available for sale securities for the three months ended March 31, 2018 and 2017 were $85.5 million and $186.5 million, respectively. Scheduled principal repayments, calls and tenders for available for sale fixed maturity securities for the three months ended March 31, 2018 and 2017 were $180.4 million and $330.8 million, respectively.

Realized gains and losses on sales are determined on the basis of specific identification of investments based on the trade date. Net realized gains on investments, excluding net OTTI losses for the three months ended March 31, 2018 and 2017, are as follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Available for sale fixed maturity securities:		
Gross realized gains	$1,382	$5,572
Gross realized losses	(2,102)	(3,563)
	(720)	2,009
Other investments:		
Gain on sale of real estate	—	29
Mortgage loans on real estate:		
Decrease in allowance for credit losses	300	300
Recovery of specific allowance	722	—
	1,022	300
	$302	$2,338

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;

Table of Contents

- 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;
- 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 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.

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

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

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

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

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

The following table presents the range of significant assumptions used to determine the credit loss component of other than temporary impairments we have recognized on residential mortgage backed securities for the three months ended

March 31, 2017, 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
Three months ended March 31, 2017							
Prime	2005	7.7%	7.7%	8 %	8 %	50%	50%
	2007	6.2%	6.3%	15%	18%	50%	60%

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.

Table of Contents

In addition, for debt securities which we do not intend to sell and it is not more likely than not we will be required to sell, but our intent changes due to changes or events that could not have been reasonably anticipated, an other than temporary impairment charge is recognized. Once an impairment charge has been recorded, we then continue to review the other than temporarily impaired securities for appropriate valuation on an ongoing basis. Unrealized losses may be recognized in future periods through a charge to earnings should we later conclude that the decline in fair value below amortized cost is other than temporary pursuant to our accounting policy described above. The use of different methodologies and assumptions to determine the fair value of investments and the timing and amount of impairments may have a material effect on the amounts presented in our consolidated financial statements.
The following table summarizes other than temporary impairments for the three months ended March 31, 2018 and 2017, 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 March 31, 2018				
Fixed maturity securities, available for sale:				
Corporate securities:				
Consumer discretionary	1	$(907)	$ —	$ (907)
Three months ended March 31, 2017				
Fixed maturity securities, available for sale:				
Residential mortgage backed securities	3	$—	$ (141)	$ (141)

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 March 31, 2018	2017
	(Dollars in thousands)	
Cumulative credit loss at beginning of period	$(157,066)	$(166,375)
Credit losses on securities for which OTTI has not previously been recognized	(907)	—
Additional credit losses on securities for which OTTI has previously been recognized	—	(141)
Accumulated losses on securities that were disposed of during the period	3,900	13,939
Cumulative credit loss at end of period	$(154,073)	$(152,577)

The following table summarizes the cumulative noncredit portion of OTTI and the change in fair value since recognition of OTTI, both of which were recognized in other comprehensive income, by major type of security, for securities that are part of our investment portfolio at March 31, 2018 and December 31, 2017:

	Amortized Cost	OTTI Recognized in Other Comprehensive Income	Change in Fair Value Since OTTI was Recognized	Fair Value
	(Dollars in thousands)			
March 31, 2018				
Fixed maturity securities, available for sale:				

Corporate securities	$17,947	$ (3,700)	$10,012	$24,259
Residential mortgage backed securities	282,835	(168,355)	198,719	313,199
Other asset backed securities	4,567	(1,356)	(1,631)	1,580
	$305,349	$ (173,411)	$207,100	$339,038
December 31, 2017				
Fixed maturity securities, available for sale:				
Corporate securities	$13,015	$ (4,263)	$10,739	$19,491
Residential mortgage backed securities	297,582	(168,355)	201,620	330,847
Other asset backed securities	4,567	(1,356)	(1,875)	1,336
	$315,164	$ (173,974)	$210,484	$351,674

20

Table of Contents

4. Mortgage Loans on Real Estate

Our mortgage loan portfolio is summarized in the following table. There were commitments outstanding of $51.7 million at March 31, 2018.

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Principal outstanding	$2,707,352	$2,674,315
Loan loss allowance	(6,496)	(7,518)
Deferred prepayment fees	(1,219)	(1,266)
Carrying value	$2,699,637	$2,665,531

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:

	March 31, 2018		December 31, 2017	
	Principal	Percent	Principal	Percent
	(Dollars in thousands)			
Geographic distribution				
East	$563,593	20.8 %	$548,067	20.5 %
Middle Atlantic	166,782	6.2 %	163,485	6.1 %
Mountain	317,872	11.7 %	308,486	11.5 %
New England	12,146	0.5 %	12,265	0.5 %
Pacific	482,593	17.8 %	466,030	17.4 %
South Atlantic	613,999	22.7 %	609,736	22.8 %
West North Central	315,339	11.6 %	324,808	12.2 %
West South Central	235,028	8.7 %	241,438	9.0 %
	$2,707,352	100.0%	$2,674,315	100.0%
Property type distribution				
Office	$270,066	10.0 %	$283,926	10.6 %
Medical Office	32,902	1.2 %	34,338	1.3 %
Retail	1,051,749	38.8 %	1,040,028	38.9 %
Industrial/Warehouse	703,892	26.0 %	677,770	25.3 %
Apartment	471,097	17.4 %	462,897	17.3 %
Mixed use/other	177,646	6.6 %	175,356	6.6 %
	$2,707,352	100.0%	$2,674,315	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.

Table of Contents

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

	Three Months Ended March 31, 2018		Three Months Ended March 31, 2017	
	Specific Allowance	General Allowance	Specific Allowance	General Allowance
	(Dollars in thousands)			
Beginning allowance balance	$(1,418)	$ (6,100)	$(1,327)	$ (7,100)
Charge-offs	—	—	—	—
Recoveries	722	—	—	—
Change in provision for credit losses	—	300	—	300
Ending allowance balance	$(696)	$ (5,800)	$(1,327)	$ (6,800)

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:

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Individually evaluated for impairment	$3,186	$ 5,445
Collectively evaluated for impairment	2,704,166	2,668,870
Total loans evaluated for impairment	$2,707,352	$ 2,674,315

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). We did not own any real estate during the three months ended March 31, 2018 and 2017.

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.

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Credit Exposure--By Payment Activity		
Performing	$2,705,957	$ 2,670,657
In workout	1,395	1,436
Collateral dependent	—	2,222
	$2,707,352	$ 2,674,315

The loans that are categorized as "in workout" consist of loans that we have agreed to lower or no mortgage payments for a period of time while the borrowers address cash flow and/or operational issues. The key features of these workouts have been determined on a loan-by-loan basis. Most of these loans are in a period of low cash flow due to tenants vacating their space or tenants requesting rent relief during difficult economic periods. Generally, we have allowed the borrower a six month interest only period and in some cases a twelve month period of interest only. Interest only workout loans are expected to return to their regular debt service payments after the interest only period. Interest only loans that are not fully amortizing will have a larger balance at their balloon date than originally contracted. Fully amortizing loans that are in interest only periods will have larger debt service payments for their remaining term due to lost principal payments during the interest only period. In limited circumstances we have

allowed borrowers to pay the principal portion of their loan payment into an escrow account that can be used for capital and tenant improvements for a period of not more than twelve months. In these situations new loan amortization schedules are calculated based on the principal not collected during this twelve month workout period and larger payments are collected for the remaining term of each loan. In all cases, the original interest rate and maturity date have not been modified, and we have not forgiven any principal amounts.
Mortgage loans are considered delinquent when they become 60 days or more past due. In general, when loans become 90 days past due, become collateral dependent or enter a period with no debt service payments required we place them on non-accrual status and discontinue recognizing interest income. If payments are received on a delinquent loan, interest income is recognized to the extent it would have been recognized if normal principal and interest would have been received timely. If payments are received to bring a delinquent loan back to current we will resume accruing interest income on that loan. There were no loans in non-accrual status at March 31, 2018. There were $2.2 million loans in non-accrual status at December 31, 2017.
We define collateral dependent loans as those mortgage loans for which we will depend on the value of the collateral real estate to satisfy the outstanding principal of the loan.

Table of Contents

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

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

	30 - 59 Days	60 - 89 Days	90 Days and Over	Total Past Due	Current	Collateral Dependent Receivables	Total Financing Receivables
	(Dollars in thousands)						
Commercial Mortgage Loans							
March 31, 2018	$ —	$ —	$ —	$ —	$ 2,707,352	$ —	$ 2,707,352
December 31, 2017	$ —	$ —	$ —	$ —	$ 2,672,093	$ 2,222	$ 2,674,315

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

	Recorded Investment	Unpaid Principal Balance	Related Allowance
	(Dollars in thousands)		
March 31, 2018			
Mortgage loans with an allowance	$ 2,490	$ 3,186	$ (696)
Mortgage loans with no related allowance	1,395	1,395	—
	$ 3,885	$ 4,581	$ (696)
December 31, 2017			
Mortgage loans with an allowance	$ 4,027	$ 5,445	$ (1,418)
Mortgage loans with no related allowance	1,436	1,436	—
	$ 5,463	$ 6,881	$ (1,418)

	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)	
Three months ended March 31, 2018		
Mortgage loans with an allowance	$ 2,509	$ 50
Mortgage loans with no related allowance	1,415	21
	$ 3,924	$ 71
Three months ended March 31, 2017		
Mortgage loans with an allowance	$ 3,291	$ 72
Mortgage loans with no related allowance	1,572	23
	$ 4,863	$ 95

Table of Contents

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

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

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

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

Mortgage loan workouts, refinances or restructures that are classified as TDRs are individually evaluated and measured for impairment. A summary of mortgage loans on commercial real estate with outstanding principal at March 31, 2018 and December 31, 2017 that we determined to be TDRs are as follows:

Geographic Region	Number of TDRs	Principal Balance Outstanding	Specific Loan Loss Allowance	Net Carrying Amount
		(Dollars in thousands)		
March 31, 2018				
South Atlantic	1	$2,930	$ —	$ 2,930
East North Central	1	1,910	(467)	1,443
	2	$4,840	$ (467)	$ 4,373
December 31, 2017				
South Atlantic	1	$2,947	$ —	$ 2,947
East North Central	1	1,933	(467)	1,466
	2	$4,880	$ (467)	$ 4,413

Table of Contents

5. Derivative Instruments

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

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Assets		
Derivative instruments		
Call options	$847,741	$ 1,568,380
Other assets		
Interest rate caps	890	415
Interest rate swap	427	—
	$849,058	$ 1,568,795
Liabilities		
Policy benefit reserves - annuity products		
Fixed index annuities - embedded derivatives	$8,233,557	$ 8,790,427
Other liabilities		
Interest rate swap	—	789
	$8,233,557	$ 8,791,216

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

	Three Months Ended March 31, 2018	2017
	(Dollars in thousands)	
Change in fair value of derivatives:		
Call options	$(452,598)	$386,736
Interest rate swap	1,040	75
Interest rate caps	475	(278)
	$(451,083)	$386,533
Change in fair value of embedded derivatives:		
Fixed index annuities—embedded derivatives	$(1,106,023)	$76,210
Other changes in difference between policy benefit reserves computed using derivative accounting vs. long-duration contracts accounting	238,791	147,960
	$(867,232)	$224,170

The amounts presented as "Other changes in difference between policy benefit reserves computed using derivative accounting vs. long-duration contracts accounting" represents the total change in the difference between policy benefit reserves for fixed index annuities computed under the derivative accounting standard and the long-duration contracts accounting standard at each balance sheet date, less the change in fair value of our fixed index annuities embedded derivatives that is presented as Level 3 liabilities in Note 2.

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

Table of Contents

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

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

			March 31, 2018		December 31, 2017	
Counterparty	Credit Rating (S&P)	Credit Rating (Moody's)	Notional Amount	Fair Value	Notional Amount	Fair Value
			(Dollars in thousands)			
Bank of America	A+	Aa3	$5,522,691	$91,549	$4,645,366	$237,955
Barclays	A	A1	3,784,024	89,471	4,135,537	154,127
BNP Paribas	A	Aa3	935,091	21,769	1,411,989	73,650
Canadian Imperial Bank of Commerce	A+	A1	4,179,179	101,280	2,808,030	84,268
Citibank, N.A.	A+	A1	4,422,448	77,256	4,104,666	219,900
Credit Suisse	A	A1	3,020,434	52,130	3,538,855	137,384
J.P. Morgan	A+	Aa3	2,118,331	85,080	1,753,649	109,689
Morgan Stanley	A+	A1	3,244,428	40,096	3,408,179	184,323
Royal Bank of Canada	AA-	A1	3,158,242	96,854	3,027,469	104,141
Societe Generale	A	A2	71,401	1,689	—	—
SunTrust	A-	Baa1	2,080,242	65,445	2,331,168	90,399
Wells Fargo	A+	Aa2	4,065,628	118,295	4,036,255	162,781
Exchange traded			260,283	6,827	296,840	9,763
			$36,862,422	$847,741	$35,498,003	$1,568,380

As of March 31, 2018 and December 31, 2017, we held $0.8 billion and $1.6 billion, respectively, of cash and cash equivalents and other securities from counterparties for derivative collateral, which is included in Other liabilities on our consolidated balance sheets. This derivative collateral limits the maximum amount of economic loss due to credit risk that we would incur if parties to the call options failed completely to perform according to the terms of the contracts to $60.2 million and $11.9 million at March 31, 2018 and December 31, 2017, respectively.

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

We entered into an interest rate swap and interest rate caps to manage interest rate risk associated with the floating rate component on certain of our subordinated debentures. See Note 10 in our Annual Report on Form 10-K for the year ended December 31, 2017 for more information on our subordinated debentures. The terms of the interest rate swap provide that we pay a fixed rate of interest and receive a floating rate of interest. The terms of the interest rate caps limit the three month LIBOR to 2.50%. The interest rate swap and caps are not effective hedges under accounting guidance for derivative instruments and hedging activities. Therefore, we record the interest rate swap and caps at fair value and any net cash payments received or paid are included in the change in fair value of derivatives in the unaudited consolidated statements of operations.

Details regarding the interest rate swap are as follows:

Maturity Date	Notional Amount	Receive Rate	Pay Rate	Counterparty	March 31, 2018 Fair Value	December 31, 2017 Fair Value
					(Dollars in thousands)	
March 15, 2021	$85,500	LIBOR	2.415%	SunTrust	$427	$ (789)

26

Table of Contents

Details regarding the interest rate caps are as follows:

Maturity Date	Notional Amount	Floating Rate	Cap Rate	Counterparty	March 31, 2018 Fair Value	December 31, 2017 Fair Value
					(Dollars in thousands)	
July 7, 2021	$40,000	LIBOR	2.50%	SunTrust	$445	$ 207
July 8, 2021	12,000	LIBOR	2.50%	SunTrust	134	62
July 29, 2021	27,000	LIBOR	2.50%	SunTrust	311	146
	$79,000				$890	$ 415

The interest rate swap converts floating rates to fixed rates for seven years which began in March 2014. The interest rate caps cap our interest rates for seven years which began in July 2014.

6. Notes Payable and Amounts Due Under Repurchase Agreements

Notes payable includes the following:

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Senior notes due 2027		
Principal	$500,000	$ 500,000
Unamortized debt issue costs	(5,457)	(5,572)
Unamortized discount	(328)	(335)
	$494,215	$ 494,093

On June 16, 2017, we issued $500 million aggregate principal amount of senior unsecured notes due 2027 which bear interest at 5.0% per year and will mature on June 15, 2027 (the "2027 Notes"). The 2027 Notes were issued at a $0.3 million discount, which is being amortized over the term of the 2027 Notes using the effective interest method. Contractual interest is payable semi-annually in arrears each June 15th and December 15th. The initial transaction fees and costs totaling $5.8 million were capitalized as deferred financing costs and are being amortized over the term of the 2027 Notes using the effective interest method.

As part of our investment strategy, we enter into securities repurchase agreements (short-term collateralized borrowings). When we do borrow cash on these repurchase agreements, we pledge collateral in the form of debt securities with fair values approximately equal to the amount due and we use the cash to purchase debt securities ahead of the time we collect the cash from selling annuity policies to avoid a lag between the investment of funds and the obligation to credit interest to policyholders. We earn investment income on the securities purchased with these borrowings at a rate in excess of the cost of these borrowings. Such borrowings averaged $7.6 million and $102.8 million and the maximum amount borrowed was $137.3 million and $274.5 million during the three months ended March 31, 2018 and March 31, 2017, respectively. The weighted average interest rate on amounts due under repurchase agreements was 1.63% and 0.64% for the three months ended March 31, 2018 and March 31, 2017, respectively.

7. Commitments and Contingencies

We are occasionally involved in litigation, both as a defendant and as a plaintiff. In addition, state regulatory bodies, such as state insurance departments, the Securities and Exchange Commission ("SEC"), Financial Industry Regulatory Authority, the Department of Labor ("DOL"), and other regulatory bodies regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, the Employee Retirement Income Security Act of 1974, as amended, and laws governing the activities of broker/dealers.

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

There can be no assurance that any pending or future litigation will not have a material adverse effect on our business, financial condition, or results of operations.

In addition to our commitments to fund mortgage loans, we have unfunded commitments at March 31, 2018 to limited partnerships of $48.4 million and to secured bank loans of $6.2 million.

Table of Contents

8. Earnings Per Share

Earnings Per Share

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

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands, except per share data)	
Numerator:		
Net income - numerator for earnings per common share	$140,962	$ 53,939
Denominator:		
Weighted average common shares outstanding	90,017,166	88,647,078
Effect of dilutive securities:		
Stock options and deferred compensation agreements	850,292	948,317
Restricted stock and restricted stock units	271,890	380,217
Denominator for earnings per common share - assuming dilution	91,139,348	89,975,612
Earnings per common share	$1.57	$ 0.61
Earnings per common share - assuming dilution	$1.55	$ 0.60

There were no options to purchase shares of our common stock outstanding excluded from the computation of diluted earnings per share during the three months ended March 31, 2018 or 2017, as the exercise price of all options outstanding was less than the average market price of our common shares for those periods.

Table of Contents

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

Management's discussion and analysis reviews our unaudited consolidated financial position at March 31, 2018, and the unaudited consolidated results of operations for the three month periods ended March 31, 2018 and 2017, and where appropriate, factors that may affect future financial performance. This analysis should be read in conjunction with our unaudited consolidated financial statements and notes thereto appearing elsewhere in this Form 10-Q, and the audited consolidated financial statements, notes thereto and selected consolidated financial data appearing in our Annual Report on Form 10-K for the year ended December 31, 2017.

Cautionary Statement Regarding Forward-Looking Information

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

- general economic conditions and other factors, including prevailing interest rate levels and stock and credit market performance which may affect (among other things) our ability to sell our products, our ability to access capital resources and the costs associated therewith, the fair value of our investments, which could result in impairments and other than temporary impairments, and certain liabilities, and the lapse rate and profitability of policies;
- customer response to new products and marketing initiatives;
- changes in Federal income tax laws and regulations which may affect the relative income tax advantages of our products;
- increasing competition in the sale of annuities;
- regulatory changes or actions, including those relating to regulation of financial services affecting (among other things) bank sales and underwriting of insurance products and regulation of the sale, underwriting and pricing of products; and
- the risk factors or uncertainties listed from time to time in our filings with the SEC.

For a detailed discussion of these and other factors that might affect our performance, see Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017.

Our Business and Profitability

We specialize in the sale of individual annuities (primarily fixed index deferred annuities). Under U.S. GAAP, premium collections for deferred annuities are reported as deposit liabilities instead of as revenues. Similarly, cash payments to policyholders are reported as decreases in the liabilities for policyholder account balances and not as expenses. Sources of revenues for products accounted for as deposit liabilities are net investment income, surrender charges assessed against policy withdrawals and fees deducted from policyholder account balances for lifetime income benefit riders, net realized gains (losses) on investments and changes in fair value of derivatives. Components of expenses for products accounted for as deposit liabilities are interest sensitive and index product benefits (primarily interest credited to account balances and changes in lifetime income benefit rider reserves), changes in fair value of embedded derivatives, amortization of deferred sales inducements and deferred policy acquisition costs, other operating costs and expenses and income taxes.

Our business model contemplates continued growth in invested assets and non-GAAP operating income while maintaining a high quality investment portfolio that will not experience significant losses from impairments of invested assets. We are committed to maintaining a high quality investment portfolio with limited exposure to below investment grade securities and other riskier assets. Growth in invested assets is predicated on a continuation of our high sales achievements of the last five years while at the same time maintaining a high level of retention of the funds received. The economic and personal investing environments continued to be conducive for high sales levels as retirees and others look to put their money in instruments that will protect their principal and provide them with consistent cash flow sources in their retirement years. However, our sales have slowed since the first half of 2016 as competition in our distribution channels escalated, rates from several of our competitors were appreciably above prior levels, and uncertainty regarding the DOL conflict of interest fiduciary rule persisted. The uncertainty regarding the DOL conflict of interest fiduciary rule was abated in the second half of 2017 following the delay of the final applicability date of the regulation and the related exemptions.

On April 6, 2016, the DOL released a final regulation which substantially expands the range of activities that will be considered to be fiduciary advice under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986. On June 9, 2017 certain provisions of the fiduciary regulation became applicable with the remainder to become effective July 1, 2019. On March 15, 2018, the United States Fifth Circuit Court of Appeals ("Fifth Circuit") issued a decision vacating the DOL fiduciary regulation. Subject to certain appeal rights, the Fifth Circuit's decision is expected to become effective on or about May 8, 2018. At that time the law regarding fiduciary status will revert back to the law in effect prior to the issuance of the DOL fiduciary regulation.

Table of Contents

Our profitability depends in large part upon:

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

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

	Three Months Ended March 31,	
	2018	2017
Average yield on invested assets	4.36%	4.48%
Aggregate cost of money	1.82%	1.77%
Aggregate investment spread	2.54%	2.71%
Impact of:		
Investment yield - additional prepayment income	0.03%	0.07%
Cost of money benefit of over hedging	0.02%	0.05%

The cost of money for fixed index annuities and average crediting rates for fixed rate annuities are computed based upon policyholder account balances and do not include the impact of amortization of deferred sales inducements. See Critical Accounting Policies - Deferred Policy Acquisition Costs and Deferred Sales Inducements included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2017.

With respect to our fixed index annuities, the cost of money includes the average crediting rate on amounts allocated to the fixed rate strategy, expenses we incur to fund the annual index credits and where applicable, minimum guaranteed interest credited. Proceeds received upon expiration of call options purchased to fund annual index credits are recorded as part of the change in fair value of derivatives, and are largely offset by an expense for interest credited to annuity policyholder account balances. See Critical Accounting Policies - Policy Liabilities for Fixed Index Annuities and Financial Condition - Derivative Instruments included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2017.

We continue to be in the midst of an unprecedented period of low interest rates and low yields for investments with the credit quality we prefer which presents a strong headwind to achieving our target rate for investment spread. In response to this, we have been reducing policyholder crediting rates for new annuities and existing annuities since the fourth quarter of 2011. We continue to have flexibility to reduce our crediting rates if necessary and could decrease our cost of money by approximately 54 basis points if we reduce current rates to guaranteed minimums. In addition, starting in 2017 we began to invest in asset classes that were not traditionally in our portfolio, focusing on investments with less liquidity that provide higher yields and have a track record of positive credit performance over time. Investment yields available to us in the first quarter of 2018 increased compared to 2017 due to an increase in interest rates on the asset classes we targeted for purchase and investment in new asset classes as noted above.

Life insurance companies are subject to the NAIC risk-based capital ("RBC") requirements which are intended to be used by insurance regulators as an early warning tool to identify deteriorating or weakly capitalized insurance companies for the purpose of initiating regulatory action. Rating agencies utilize a form of RBC to partially determine capital strength of insurance companies. Our RBC ratio at December 31, 2017 was 378%, and our estimated RBC ratio at March 31, 2018 was 383%.

Table of Contents

Results of Operations for the Three Months Ended March 31, 2018 and 2017

Annuity deposits by product type collected during the three months ended March 31, 2018 and 2017, were as follows:

Product Type	Three Months Ended March 31, 2018	2017
	(Dollars in thousands)	
Fixed index annuities	$993,914	$1,028,839
Annual reset fixed rate annuities	16,490	14,843
Multi-year fixed rate annuities	10,025	29,901
Single premium immediate annuities	10,630	5,551
Total before coinsurance ceded	1,031,059	1,079,134
Coinsurance ceded	89,695	71,074
Net after coinsurance ceded	$941,364	$1,008,060

Annuity deposits before and after coinsurance ceded decreased 4% and 7%, respectively, during the first quarter of 2018 compared to the same period in 2017. The decrease in sales for the three months ended March 31, 2018 as compared to the same period in 2017 primarily reflects continued competitive pressures within each of our distribution channels. In addition, we continued to face a challenging environment for sales of fixed index annuities during the first quarter of 2018 due to low interest rates and strong equity markets. The relatively larger decline in net sales compared to gross sales is due to an increase in coinsurance ceded premiums as a result of an increase in Eagle Life Insurance Company's ("Eagle Life") fixed index annuity sales during the first quarter of 2018 as compared to the same period in 2017.

We coinsure 80% of the annuity deposits received from MYGA fixed annuity products and 50% of the fixed index annuities sold by Eagle Life through broker/dealers and banks. The changes in coinsurance ceded premiums are attributable to changes in premiums from these sources.

Net income increased to $141.0 million in the first quarter of 2018 compared to $53.9 million for the same period in 2017.

Net income, in general, has been positively impacted by the growth in the volume of business in force and the investment spread earned on this business. The average amount of annuity account balances outstanding (net of annuity liabilities ceded under coinsurance agreements) increased 7% to $48.8 billion for the first quarter of 2018 compared to $45.6 billion for the same period in 2017. Our investment spread measured in dollars was $283.6 million for the first quarter of 2018 compared to $278.6 million for the same period in 2017. As previously mentioned, our investment spread has been negatively impacted by the extended low interest rate environment (see Net investment income).

Net income is also impacted by the change in fair value of derivatives and embedded derivatives which fluctuates from period to period based upon changes in fair values of call options purchased to fund the annual index credits for fixed index annuities and changes in interest rates used to discount the embedded derivative liability. Net income for the three months ended March 31, 2018 was positively impacted by increases in the discount rates used to estimate the fair value of our embedded derivative liability while net income for the three months ended March 31, 2017 was negatively impacted by decreases in those same discount rates (see Change in fair value of derivatives and Change in fair value of embedded derivatives).

Net income for the three months ended March 31, 2018 was also positively impacted by a decrease in the tax rate as a result of Tax Reform (see Income taxes).

Non-GAAP operating income, a non-GAAP financial measure, increased to $77.7 million in the first quarter of 2018 compared to $59.6 million for the same period in 2017.

In addition to net income, we have consistently utilized non-GAAP operating income, a non-GAAP financial measure commonly used in the life insurance industry, as an economic measure to evaluate our financial performance. Non-GAAP operating income equals net income adjusted to eliminate the impact of items that fluctuate from quarter to quarter in a manner unrelated to core operations, and we believe measures excluding their impact are useful in analyzing operating trends. The most significant adjustments to arrive at non-GAAP operating income eliminate the impact of fair value accounting for our fixed index annuity business and are not economic in nature but rather impact the timing of reported results. We believe the combined presentation and evaluation of non-GAAP operating income together with net income provides information that may enhance an investor's understanding of our underlying results and profitability.

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

Table of Contents

The adjustments made to net income to arrive at non-GAAP operating income for the three months ended March 31, 2018 and 2017 are set forth in the table that follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Reconciliation from net income to non-GAAP operating income:		
Net income	$140,962	$53,939
Adjustments to arrive at non-GAAP operating income:		
Net realized investment (gains) losses, including OTTI	23	(1,942)
Change in fair value of derivatives and embedded derivatives - fixed index annuities	(78,818)	10,977
Change in fair value of derivatives - debt	(1,832)	(247)
Income taxes	17,359	(3,105)
Non-GAAP operating income	$77,694	$59,622

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

Annuity product charges (surrender charges assessed against policy withdrawals and fees deducted from policyholder account balances for lifetime income benefit riders) increased 16% to $50.7 million in the first quarter of 2018 compared to $43.6 million for the same period in 2017. The components of annuity product charges are set forth in the table that follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Surrender charges	$16,282	$13,634
Lifetime income benefit riders (LIBR) fees	34,441	29,938
	$50,723	$43,572
Withdrawals from annuity policies subject to surrender charges	$129,996	$107,219
Average surrender charge collected on withdrawals subject to surrender charges	12.5%	12.7%
Fund values on policies subject to LIBR fees	$4,782,117	$4,296,670
Weighted average per policy LIBR fee	0.72%	0.70%

The increase in annuity product charges was primarily attributable to an increase in fees assessed for lifetime income benefit riders due to a larger volume of business in force subject to the fee and an increase in the average fees being charged due to higher fees on new products as compared to prior periods. See Interest sensitive and index product benefits below for corresponding expense recognized on lifetime income benefit riders. Surrender charges increased in the first quarter of 2018 as compared to the same period in 2017 due to an increase in withdrawals from annuity policies subject to surrender charges during the first quarter of 2018 as compared to the same period in 2017.

Net investment income increased 5% to $510.8 million in the first quarter of 2018 compared to $485.6 million for the same period in 2017. The increase was principally attributable to the growth in our annuity business and corresponding increases in our invested assets. Average invested assets excluding derivative instruments (on an amortized cost basis) increased 8% to $46.9 billion for the first quarter of 2018 compared to $43.6 billion for the same period in 2017.

The average yield earned on average invested assets was 4.36% for the first quarter of 2018 compared to 4.48% for the same period in 2017. The decrease in yield earned on average invested assets was attributable to investment of new premiums and portfolio cash flows during 2017 at rates below the overall portfolio yield. The average yield on fixed income securities purchased and commercial mortgage loans funded during the three months ended March 31, 2018 was 4.43%, compared to 4.13% for the same period in 2017. The unfavorable impact from lower new money investment yields was offset by non-trendable investment income items which added three and seven basis points to the average yield on invested assets for the first quarter of 2018 and 2017.

32

Table of Contents

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

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Call options:		
Gain (loss) on option expiration	$291,976	$205,400
Change in unrealized gains/losses	(744,574)	181,336
Interest rate swap	1,040	75
Interest rate caps	475	(278)
	$(451,083)	$386,533

The differences between the change in fair value of derivatives between periods for call options are primarily due to the performance of the indices upon which our call options are based which impacts the market values and changes in the market values of those call options between periods. A substantial portion of our call options are based upon the S&P 500 Index with the remainder based upon other equity and bond market indices. The range of index appreciation (after applicable caps, participation rates and asset fees) for options expiring during the three months ended March 31, 2018 and 2017 is as follows:

	Three Months Ended March 31,	
	2018	2017
S&P 500 Index		
Point-to-point strategy	1.0% - 12.6%	1.0% - 13.3%
Monthly average strategy	0.6% - 8.0%	0.1% - 10.6%
Monthly point-to-point strategy	0.0% - 17.5%	0.0% - 15.2%
Fixed income (bond index) strategies	0.0% - 2.5%	0.0% - 4.1%

The change in fair value of derivatives is also influenced by the aggregate cost of options purchased. The aggregate cost of options has increased primarily due to an increased amount of fixed index annuities in force as well as an increase in the cost of options for certain index strategies which began during the second half of 2017. The aggregate cost of options is also influenced by the amount of policyholder funds allocated to the various indices and market volatility which affects option pricing. See Critical Accounting Policies - Policy Liabilities for Fixed Index Annuities included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2017.

Net realized gains on investments, excluding OTTI losses include gains and losses on the sale of securities and impairment losses on mortgage loans on real estate which fluctuate from year to year due to changes in the interest rate and economic environment and the timing of the sale of investments, as well as gains (losses) recognized on real estate owned due to any sales and impairments on long-lived assets. See Note 3 to our unaudited consolidated financial statements for a detailed presentation of the types of investments that generated the gains (losses).

Losses on available for sale fixed maturity securities were realized primarily due to strategies to reposition the fixed maturity security portfolio that resulted in improved net investment income, risk or duration profiles as they pertain to our asset liability management. See Financial Condition - Investments and Note 4 to our unaudited consolidated financial statements for additional discussion of allowance for credit losses recognized on mortgage loans on real estate.

Net OTTI losses recognized in operations increased to $0.9 million in the first quarter of 2018 compared to $0.1 million for the same period in 2017. See Financial Condition - Other Than Temporary Impairments for additional discussion of other than temporary impairments recognized during the periods presented.

Interest sensitive and index product benefits increased 23% to $514.1 million in the first quarter of 2018 compared to $419.1 million for the same period in 2017. The components of interest sensitive and index product benefits are summarized as follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Index credits on index policies	$423,940	$321,880
Interest credited (including changes in minimum guaranteed interest for fixed index annuities)	56,770	67,006
Lifetime income benefit riders	33,385	30,253
	$514,095	$419,139

33

Table of Contents

The increase in index credits was attributable to changes in the level of appreciation of the underlying indices (see discussion above under Change in fair value of derivatives) and the amount of funds allocated by policyholders to the respective index options. Total proceeds received upon expiration of the call options purchased to fund the annual index credits were $425.6 million for the three months ended March 31, 2018, compared to $326.6 million for the same period in 2017. The decrease in interest credited was due to decreases in the average rate credited to the annuity liabilities outstanding receiving a fixed rate of interest and the amount of annuity liabilities outstanding receiving a fixed rate of interest. The increase in benefits recognized for lifetime income benefit riders was due to an increase in the number of policies with lifetime income benefit riders which correlates to the increase in fees discussed in Annuity product charges.

The reserve (net of coinsurance ceded) held for lifetime income benefit riders was $737.8 million and $704.4 million at March 31, 2018 and December 31, 2017, respectively.

Amortization of deferred sales inducements, in general, has been increasing each period due to growth in our annuity business and the deferral of sales inducements incurred with respect to sales of premium bonus annuity products. Bonus products represented 86% and 88% of our net annuity account values at March 31, 2018 and March 31, 2017, respectively. The increases in amortization from these factors have been affected by amortization associated with fair value accounting for derivatives and embedded derivatives utilized in our fixed index annuity business and amortization associated with net realized gains (losses) on investments and net OTTI losses recognized in operations. Fair value accounting for derivatives and embedded derivatives utilized in our fixed index annuity business creates differences in the recognition of revenues and expenses from derivative instruments including the embedded derivative liabilities in our fixed index annuity contracts. The change in fair value of the embedded derivatives will not correspond to the change in fair value of the derivatives (purchased call options), because the purchased call options are one-year options while the options valued in the fair value of embedded derivatives cover the expected lives of the contracts which typically exceed ten years. Amortization of deferred sales inducements is summarized as follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Amortization of deferred sales inducements before gross profit adjustments	$67,211	$67,784
Gross profit adjustments:		
Fair value accounting for derivatives and embedded derivatives	33,456	(5,588)
Net realized gains (losses) on investments and net OTTI losses recognized in operations	(244)	129
Amortization of deferred sales inducements after gross profit adjustments	$100,423	$62,325

Change in fair value of embedded derivatives includes changes in the fair value of our fixed index annuity embedded derivatives (see Note 5 to our unaudited consolidated financial statements). The components of change in fair value of embedded derivatives are as follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Fixed index annuities - embedded derivatives	$(1,106,023)	$76,210
Other changes in difference between policy benefit reserves computed using derivative accounting vs. long-duration contracts accounting	238,791	147,960
	$(867,232)	$224,170

The change in fair value of the fixed index annuity embedded derivatives resulted from (i) changes in the expected index credits on the next policy anniversary dates, which are related to the change in fair value of the call options acquired to fund those index credits discussed above in Change in fair value of derivatives; (ii) changes in discount rates used in estimating our embedded derivative liabilities; and (iii) the growth in the host component of the policy liability. The amounts presented as "Other changes in difference between policy benefit reserves computed using derivative accounting vs. long-duration contracts accounting" represents the total change in the difference between policy benefit reserves for fixed index annuities computed under the derivative accounting standard and the long-duration contracts accounting standard at each balance sheet date, less the change in fair value of our fixed index annuities embedded derivative. See Critical Accounting Policies - Policy Liabilities for Fixed Index Annuities included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2017. The primary reasons for the decrease in the change in fair value of the fixed index annuity embedded derivatives during the three months ended March 31, 2018 were decreases in the expected index credits on the next policy anniversary dates resulting from decreases in the fair value of the call options acquired to fund these index credits during the three months ended March 31, 2018 as compared to the increases in the expected index credits due to increases in the fair value of the call options for the same period of 2017 and increases in the discount rates used in estimating the fair value of our embedded derivative liabilities during the three months ended March 31, 2018 as compared to decreases in those same discount rates for the same period of 2017. The discount rates used in estimating our embedded derivative liabilities fluctuate based on changes in the general level of interest rates and credit spreads both of which increased during the three months ended March 31, 2018.

Interest expense on notes and loan payable decreased 17% to $6.4 million in the first quarter of 2018 compared to $7.7 million for the same period in 2017. Interest expense by debt instrument is as follows:

Table of Contents

	Three Months Ended March 31, 2018	2017
	(Dollars in thousands)	
2027 Notes	$6,372	$—
2021 Notes	—	6,896
Term loan due 2019	—	826
	$6,372	$7,722

The decrease in interest expense for the three months ended March 31, 2018 was due to the repayment of our outstanding $100 million term loan and the refinancing of our $400 million 6.625% notes due 2021 with the issuance of the 2027 Notes. This lowered our senior notes costs to 5% from 6.625%.

Amortization of deferred policy acquisition costs, in general, has been increasing each period due to the growth in our annuity business and the deferral of policy acquisition costs incurred with respect to sales of annuity products. The increases in amortization from these factors have been affected by amortization associated with fair value accounting for derivatives and embedded derivatives utilized in our fixed index annuity business and amortization associated with net realized gains (losses) on investments and net OTTI losses recognized in operations. As discussed above, fair value accounting for derivatives and embedded derivatives utilized in our fixed index annuity business creates differences in the recognition of revenues and expenses from derivative instruments including the embedded derivative liabilities in our fixed index annuity contracts. Amortization of deferred policy acquisition costs is summarized as follows:

	Three Months Ended March 31, 2018	2017
	(Dollars in thousands)	
Amortization of deferred policy acquisition costs before gross profit adjustments	$95,440	$95,431
Gross profit adjustments:		
Fair value accounting for derivatives and embedded derivatives	45,537	(5,878)
Net realized gains (losses) on investments and net OTTI losses recognized in operations	(338)	125
Amortization of deferred policy acquisition costs after gross profit adjustments	$140,639	$89,678

Other operating costs and expenses increased 13.3% to $31.2 million in the first quarter of 2018 compared to $27.6 million for the same period in 2017 and are summarized as follows:

	Three Months Ended March 31, 2018	2017
	(Dollars in thousands)	
Salary and benefits	$16,387	$13,777
Risk charges	7,679	7,055
Other	7,174	6,747
Total other operating costs and expenses	$31,240	$27,579

The three months ended March 31, 2018 reflect an increase in salary and benefits of $0.9 million due to an increased number of employees related to our growth and an increase of $1.9 million related to expense recognized under our incentive compensation program and other bonus programs as compared to the same period in 2017. The increase in expenses related to our incentive compensation program and other bonus programs during the three months ended

March 31, 2018 as compared to the same period in 2017 was primarily due to an increase in the percentage of restricted stock units granted that were earned or are expected to be earned and an increase in expected payouts under various company bonus plans due to an increased number of employees participating in certain plans and a higher potential payout for certain employees participating in certain plans.

The increase in reinsurance risk charges expense for the three months ended March 31, 2018 as compared to the same period in 2017 was due to growth in our policyholder liabilities subject to the reinsurance agreement pursuant to which we cede excess regulatory reserves to an unaffiliated reinsurer. The regulatory reserves ceded at March 31, 2018 and 2017 were $754.0 million and $690.9 million, respectively.

Income tax expense was $36.6 million in the first quarter of 2018 compared to $27.5 million for the same period in 2017. The change in income tax expense was primarily due to changes in income before income taxes as well as changes in the tax rate as a result of Tax Reform. The effective income tax rates were 20.6% and 33.8% for the three months ended March 31, 2018 and 2017, respectively.

Table of Contents

Income tax expense and the resulting effective tax rate are based upon two components of income before income taxes ("pretax income") that are taxed at different tax rates. Life insurance income is generally taxed at an effective rate of approximately 21.6% reflecting the absence of state income taxes for substantially all of the states that the life insurance subsidiaries do business in. The income for the parent company and other non-life insurance subsidiaries (the "non-life insurance group") is generally taxed at an effective tax rate of 29.5% reflecting the combined federal / state income tax rates. Prior to Tax Reform, life insurance income was generally taxed at an effective rate of approximately 35.6% while income for the non-life insurance group was generally taxed at an effective tax rate of 41.5% reflecting the combined federal / state income tax rates. The effective income tax rates resulting from the combination of the income tax provisions for the life / non-life sources of income vary from period to period based primarily on the relative size of pretax income from the two sources.

The effective income tax rate was impacted by a discrete tax item related to share-based compensation that reduced income tax expense for the three months ended March 31, 2018 and 2017 by approximately $1.6 million and $1.3 million, respectively.

Table of Contents

Financial Condition

Investments

Our investment strategy is to maintain a predominantly investment grade fixed income portfolio, provide adequate liquidity to meet our cash obligations to policyholders and others and maximize current income and total investment return through active investment management. Consistent with this strategy, our investments principally consist of fixed maturity securities and mortgage loans on real estate.

Insurance statutes regulate the type of investments that our life subsidiaries are permitted to make and limit the amount of funds that may be used for any one type of investment. In light of these statutes and regulations and our business and investment strategy, we generally seek to invest in United States government and government-sponsored agency securities, corporate securities, residential and commercial mortgage backed securities, other asset backed securities and United States municipalities, states and territories securities rated investment grade by established NRSRO's or in securities of comparable investment quality, if not rated, and commercial mortgage loans on real estate.

The composition of our investment portfolio is summarized as follows:

	March 31, 2018		December 31, 2017	
	Carrying Amount	Percent	Carrying Amount	Percent
	(Dollars in thousands)			
Fixed maturity securities:				
United States Government full faith and credit	$11,433	— %	$11,876	— %
United States Government sponsored agencies	1,270,106	2.6 %	1,305,017	2.6 %
United States municipalities, states and territories	4,137,005	8.3 %	4,166,812	8.3 %
Foreign government obligations	231,671	0.5 %	239,360	0.5 %
Corporate securities	29,661,171	59.7 %	29,956,012	59.6 %
Residential mortgage backed securities	1,102,609	2.2 %	1,105,567	2.2 %
Commercial mortgage backed securities	5,596,882	11.3 %	5,544,850	11.0 %
Other asset backed securities	3,617,514	7.3 %	3,120,536	6.2 %
Total fixed maturity securities	45,628,391	91.9 %	45,450,030	90.4 %
Mortgage loans on real estate	2,699,637	5.4 %	2,665,531	5.3 %
Derivative instruments	847,741	1.7 %	1,568,380	3.1 %
Other investments	481,825	1.0 %	616,764	1.2 %
	$49,657,594	100.0%	$50,300,705	100.0%

Fixed Maturity Securities

Our fixed maturity security portfolio is managed to minimize risks such as interest rate changes and defaults or impairments while earning a sufficient and stable return on our investments. The largest portion of our fixed maturity securities are in investment grade (NAIC designation 1 or 2) publicly traded or privately placed corporate securities.

A summary of our fixed maturity securities by NRSRO ratings is as follows:

	March 31, 2018		December 31, 2017	
Rating Agency Rating	Carrying Amount	Percent of Fixed Maturity Securities	Carrying Amount	Percent of Fixed Maturity Securities
	(Dollars in thousands)			
Aaa/Aa/A	$27,823,308	61.0 %	$27,909,879	61.4 %
Baa	16,267,301	35.7 %	16,048,610	35.3 %
Total investment grade	44,090,609	96.7 %	43,958,489	96.7 %
Ba	1,097,231	2.4 %	1,035,676	2.3 %
B	156,922	0.3 %	130,857	0.3 %

Caa	152,903	0.3	%	134,586	0.3	%
Ca and lower	130,726	0.3	%	190,422	0.4	%
Total below investment grade	1,537,782	3.3	%	1,491,541	3.3	%
	$45,628,391	100.0	%	$45,450,030	100.0	%

Table of Contents

The NAIC's Securities Valuation Office ("SVO") is responsible for the day-to-day credit quality assessment and the valuation of fixed maturity securities owned by state regulated insurance companies. The purpose of such assessment and valuation is for determining regulatory capital requirements and regulatory reporting. Insurance companies report ownership to the SVO when such securities are eligible for regulatory filings. The SVO conducts credit analysis on these securities for the purpose of assigning a NAIC designation and/or unit price. Typically, if a security has been rated by a NRSRO, the SVO utilizes that rating and assigns a NAIC designation based upon the following system:

NAIC Designation	NRSRO Equivalent Rating
1	Aaa/Aa/A
2	Baa
3	Ba
4	B
5	Caa
6	Ca and lower

For most of the bonds held in our portfolio the NAIC designation matches the NRSRO equivalent rating. However, for certain loan-backed and structured securities, as defined by the NAIC, the NAIC rating is not always equivalent to the NRSRO rating presented in the previous table. The NAIC has adopted revised rating methodologies for certain loan-backed and structured securities comprised of non-agency residential mortgage backed securities ("RMBS") and commercial mortgage backed securities ("CMBS"). The NAIC’s objective with the revised rating methodologies for these structured securities is to increase the accuracy in assessing expected losses and use the improved assessment to determine a more appropriate capital requirement for such structured securities. The revised methodologies reduce regulatory reliance on rating agencies and allow for greater regulatory input into the assumptions used to estimate expected losses from structured securities.

The use of this process by the SVO may result in certain non-agency RMBS and CMBS being assigned a NAIC designation that is higher than the equivalent NRSRO rating. The NAIC designations for non-agency RMBS and CMBS are based on security level expected losses as modeled by an independent third party (engaged by the NAIC) and the statutory carrying value of the security, including any purchase discounts or impairment charges previously recognized. Evaluation of non-agency RMBS and CMBS held by insurers using the NAIC rating methodologies is performed on an annual basis.

As stated previously, our fixed maturity security portfolio is managed to minimize risks such as defaults or impairments while earning a sufficient and stable return on our investments. Our strategy has been to invest primarily in investment grade fixed maturity securities. Investment grade is NAIC 1 and 2 securities and Baa3/BBB- and better securities on the NRSRO scale. This strategy meets the objective of minimizing risk while also managing asset capital charges on a regulatory capital basis.

A summary of our fixed maturity securities by NAIC designation is as follows:

	March 31, 2018				December 31, 2017			
NAIC Designation	Amortized Cost	Fair Value	Carrying Amount	Percent of Total Carrying Amount	Amortized Cost	Fair Value	Carrying Amount	Percent of Total Carrying Amount
	(Dollars in thousands)				(Dollars in thousands)			
1	$27,142,276	$27,984,297	$27,984,297	61.3 %	$26,669,427	$28,274,379	$28,274,379	62.2 %
2	15,897,296	16,147,267	16,147,267	35.4 %	15,198,551	15,869,219	15,869,219	34.9 %
3	1,350,395	1,316,146	1,323,748	2.9 %	1,161,737	1,157,420	1,158,001	2.5 %
4	170,754	145,085	145,085	0.3 %	134,838	117,542	117,542	0.3 %
5	17,108	19,926	19,926	0.1 %	17,015	20,927	20,927	0.1 %
6	10,027	8,068	8,068	— %	12,232	9,962	9,962	— %
	$44,587,856	$45,620,789	$45,628,391	100.0 %	$43,193,800	$45,449,449	$45,450,030	100.0 %

The amortized cost and fair value of fixed maturity securities at March 31, 2018, by contractual maturity, are presented in Note 3 to our unaudited consolidated financial statements in this form 10-Q, which is incorporated by reference in this Item 2.

Table of Contents

Unrealized Losses

The amortized cost and fair value of fixed maturity securities that were in an unrealized loss position were as follows:

	Number of Securities	Amortized Cost	Unrealized Losses	Fair Value
		(Dollars in thousands)		
March 31, 2018				
Fixed maturity securities, available for sale:				
United States Government full faith and credit	7	$9,946	$(373)	$9,573
United States Government sponsored agencies	23	1,066,663	(59,340)	1,007,323
United States municipalities, states and territories	109	361,880	(12,855)	349,025
Foreign government obligations	5	144,365	(4,448)	139,917
Corporate securities:				
Finance, insurance and real estate	233	2,675,585	(94,923)	2,580,662
Manufacturing, construction and mining	160	1,655,748	(47,358)	1,608,390
Utilities and related sectors	201	2,128,891	(59,670)	2,069,221
Wholesale/retail trade	85	961,791	(33,255)	928,536
Services, media and other	420	4,522,525	(168,624)	4,353,901
Residential mortgage backed securities	44	318,435	(7,004)	311,431
Commercial mortgage backed securities	470	3,926,931	(121,506)	3,805,425
Other asset backed securities	144	999,664	(14,633)	985,031
	1,901	$18,772,424	$(623,989)	$18,148,435
Fixed maturity securities, held for investment:				
Corporate security:				
Insurance	1	$77,043	$(7,602)	$69,441
December 31, 2017				
Fixed maturity securities, available for sale:				
United States Government full faith and credit	4	$8,443	$(147)	$8,296
United States Government sponsored agencies	18	1,035,489	(31,730)	1,003,759
United States municipalities, states and territories	48	176,831	(3,596)	173,235
Foreign government obligations	2	64,313	(2,025)	62,288
Corporate securities:				
Finance, insurance and real estate	92	1,090,077	(33,178)	1,056,899
Manufacturing, construction and mining	55	468,505	(14,324)	454,181
Utilities and related sectors	63	657,599	(13,000)	644,599
Wholesale/retail trade	31	344,196	(12,620)	331,576
Services, media and other	165	1,693,343	(72,565)	1,620,778
Residential mortgage backed securities	20	75,159	(2,471)	72,688
Commercial mortgage backed securities	310	2,473,034	(69,840)	2,403,194
Other asset backed securities	146	996,531	(13,405)	983,126
	954	$9,083,520	$(268,901)	$8,814,619
Fixed maturity securities, held for investment:				
Corporate security:				
Insurance	1	$77,041	$(581)	$76,460

The increase in unrealized losses from December 31, 2017 to March 31, 2018 was primarily due to an increase in interest rates in addition to price deterioration due to wider credit spreads as of March 31, 2018. The 10-year U.S. Treasury yields at March 31, 2018 and December 31, 2017 were 2.74% and 2.40%, respectively. The 30-year U.S. Treasury yields at March 31, 2018 and December 31, 2017 were 2.97% and 2.74%, respectively.

Table of Contents

The following table sets forth the composition by credit quality (NAIC designation) of fixed maturity securities with gross unrealized losses:

NAIC Designation	Carrying Value of Securities with Gross Unrealized Losses	Percent of Total	Gross Unrealized Losses	Percent of Total
	(Dollars in thousands)			
March 31, 2018				
1	$10,959,521	60.1 %	$(366,296)	58.0 %
2	6,387,958	35.1 %	(188,558)	29.8 %
3	737,227	4.0 %	(44,604)	7.1 %
4	128,328	0.7 %	(25,864)	4.1 %
5	9,551	0.1 %	(3,126)	0.5 %
6	2,893	— %	(3,143)	0.5 %
	$18,225,478	100.0%	$(631,591)	100.0%
December 31, 2017				
1	$5,433,608	61.1 %	$(158,991)	59.0 %
2	2,809,981	31.6 %	(64,369)	23.9 %
3	540,320	6.1 %	(23,166)	8.6 %
4	94,004	1.1 %	(17,972)	6.7 %
5	11,130	0.1 %	(1,460)	0.5 %
6	2,617	— %	(3,524)	1.3 %
	$8,891,660	100.0%	$(269,482)	100.0%

Our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities (consisting of 1,902 and 955 securities, respectively) have been in a continuous unrealized loss position at March 31, 2018 and December 31, 2017, along with a description of the factors causing the unrealized losses is presented in Note 3 to our unaudited consolidated financial statements in this Form 10-Q, which is incorporated by reference in this Item 2.

Table of Contents

The amortized cost and fair value of fixed maturity securities in an unrealized loss position and the number of months in a continuous unrealized loss position (fixed maturity securities that carry an NRSRO rating of BBB/Baa or higher are considered investment grade) were as follows:

	Number of Securities	Amortized Cost	Fair Value	Gross Unrealized Losses
		(Dollars in thousands)		
March 31, 2018				
Fixed maturity securities:				
Investment grade:				
Less than six months	1,215	$11,893,032	$11,684,032	$(209,000)
Six months or more and less than twelve months	165	1,484,739	1,425,452	(59,287)
Twelve months or greater	427	4,646,882	4,354,841	(292,041)
Total investment grade	1,807	18,024,653	17,464,325	(560,328)
Below investment grade:				
Less than six months	35	284,001	277,609	(6,392)
Six months or more and less than twelve months	15	73,259	65,402	(7,857)
Twelve months or greater	45	467,554	410,540	(57,014)
Total below investment grade	95	824,814	753,551	(71,263)
	1,902	$18,849,467	$18,217,876	$(631,591)
December 31, 2017				
Fixed maturity securities:				
Investment grade:				
Less than six months	409	$3,550,774	$3,520,164	$(30,610)
Six months or more and less than twelve months	27	257,924	249,690	(8,234)
Twelve months or greater	430	4,668,838	4,486,239	(182,599)
Total investment grade	866	8,477,536	8,256,093	(221,443)
Below investment grade:				
Less than six months	32	201,885	194,821	(7,064)
Six months or more and less than twelve months	12	36,595	34,619	(1,976)
Twelve months or greater	45	444,545	405,546	(38,999)
Total below investment grade	89	683,025	634,986	(48,039)
	955	$9,160,561	$8,891,079	$(269,482)

Table of Contents

The amortized cost and fair value of fixed maturity securities (excluding United States Government and United States Government sponsored agency securities) segregated by investment grade (NRSRO rating of BBB/Baa or higher) and below investment grade that had unrealized losses greater than 20% and the number of months in a continuous unrealized loss position were as follows:

	Number of Securities	Amortized Cost	Fair Value	Gross Unrealized Losses
		(Dollars in thousands)		
March 31, 2018				
Investment grade:				
Less than six months	—	$—	$—	$—
Six months or more and less than twelve months	—	—	—	—
Twelve months or greater	—	—	—	—
Total investment grade	—	—	—	—
Below investment grade:				
Less than six months	3	50,156	39,169	(10,987)
Six months or more and less than twelve months	1	3,521	2,297	(1,224)
Twelve months or greater	3	39,191	24,477	(14,714)
Total below investment grade	7	92,868	65,943	(26,925)
	7	$92,868	$65,943	$(26,925)
December 31, 2017				
Investment grade:				
Less than six months	3	$8,597	$6,931	$(1,666)
Six months or more and less than twelve months	—	—	—	—
Twelve months or greater	—	—	—	—
Total investment grade	3	8,597	6,931	(1,666)
Below investment grade:				
Less than six months	1	11,021	8,275	(2,746)
Six months or more and less than twelve months	1	3,523	2,674	(849)
Twelve months or greater	4	55,647	37,591	(18,056)
Total below investment grade	6	70,191	48,540	(21,651)
	9	$78,788	$55,471	$(23,317)

Table of Contents

The amortized cost and fair value of fixed maturity securities, by contractual maturity, that were in an unrealized loss position 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 a separate line.

	Available for sale		Held for investment	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
March 31, 2018				
Due in one year or less	$—	$—	$—	$—
Due after one year through five years	2,167,775	2,130,293	—	—
Due after five years through ten years	6,063,714	5,891,646	—	—
Due after ten years through twenty years	2,490,238	2,369,431	—	—
Due after twenty years	2,805,667	2,655,178	77,043	69,441
	13,527,394	13,046,548	77,043	69,441
Residential mortgage backed securities	318,435	311,431	—	—
Commercial mortgage backed securities	3,926,931	3,805,425	—	—
Other asset backed securities	999,664	985,031	—	—
	$18,772,424	$18,148,435	$77,043	$69,441
December 31, 2017				
Due in one year or less	$—	$—	$—	$—
Due after one year through five years	463,667	454,062	—	—
Due after five years through ten years	1,996,166	1,945,474	—	—
Due after ten years through twenty years	1,937,009	1,881,162	—	—
Due after twenty years	1,141,954	1,074,913	77,041	76,460
	5,538,796	5,355,611	77,041	76,460
Residential mortgage backed securities	75,159	72,688	—	—
Commercial mortgage backed securities	2,473,034	2,403,194	—	—
Other asset backed securities	996,531	983,126	—	—
	$9,083,520	$8,814,619	$77,041	$76,460

International Exposure

We hold fixed maturity securities with international exposure. As of March 31, 2018, 19% of the carrying value of our fixed maturity securities was comprised of corporate debt securities of issuers based outside of the United States and debt securities of foreign governments. Our investment professionals analyze each holding for credit risk by economic and other factors of each country and industry. The following table presents our international exposure in our fixed maturity portfolio by country or region:

	March 31, 2018		
	Amortized Cost	Carrying Amount/ Fair Value	Percent of Total Carrying Amount
	(Dollars in thousands)		
GIIPS (1)	$265,668	$280,715	0.6%
Asia/Pacific	433,877	441,770	1.0%
Non-GIIPS Europe	3,100,441	3,157,021	6.9%
Latin America	291,117	298,767	0.7%
Non-U.S. North America	1,346,732	1,387,196	3.0%

Australia & New Zealand	767,242	757,598	1.7%
Other	2,475,918	2,488,042	5.4%
	$8,680,995	$8,811,109	19.3%

(1) Greece, Ireland, Italy, Portugal and Spain ("GIIPS"). All of our exposure in GIIPS are corporate securities with issuers domiciled in these countries. None of our foreign government obligations were held in any of these countries.

Table of Contents

All of the securities presented in the table above are denominated in U.S. dollars and all are investment grade (NAIC designation of either 1 or 2), except for the following:

	March 31, 2018	
	Amortized Cost	Carrying Amount/ Fair Value
	(Dollars in thousands)	
GIIPS	$19,515	$21,013
Asia/Pacific	11,000	9,500
Non-GIIPS Europe	194,558	191,198
Latin America	59,577	55,507
Non-U.S. North America	76,725	76,584
	$361,375	$353,802

Watch List

At each balance sheet date, we identify invested assets which have characteristics (i.e. significant unrealized losses compared to amortized cost and industry trends) creating uncertainty as to our future assessment of an other than temporary impairment. As part of this assessment, we review not only a change in current price relative to its amortized cost but the issuer's current credit rating and the probability of full recovery of principal based upon the issuer's financial strength. Specifically for corporate issues we evaluate the financial stability and quality of asset coverage for the securities relative to the term to maturity for the issues we own. A security which has a 25% or greater change in market price relative to its amortized cost and a possibility of a loss of principal will be included on a list which is referred to as our watch list. We exclude from this list securities with unrealized losses which are related to market movements in interest rates and which have no factors indicating that such unrealized losses may be other than temporary as we do not intend to sell these securities and it is more likely than not we will not have to sell these securities before a recovery is realized. In addition, we exclude our residential and commercial mortgage backed securities as we monitor all of our residential and commercial mortgage backed securities on a quarterly basis for changes in default rates, loss severities and expected cash flows for the purpose of assessing potential other than temporary impairments and related credit losses to be recognized in operations. At March 31, 2018, the amortized cost and fair value of securities on the watch list (all fixed maturity securities) are as follows:

General Description	Number of Securities	Amortized Cost	Unrealized Gains (Losses)	Fair Value	Months in Continuous Unrealized Loss Position	Months Unrealized Losses Greater Than 20%
		(Dollars in thousands)				
Below investment grade						
Corporate securities:						
Consumer discretionary	2	$25,974	$(5,061)	$20,913	4 - 38	0 - 1
Energy	4	29,054	(6,538)	22,516	2 - 43	0 - 8
Industrials	1	2,585	(785)	1,800	41	1
Materials	1	3,990	1,172	5,162	—	—
Other asset backed securities:						
Financials	2	6,036	(3,143)	2,893	58 - 84	0 - 39
	10	$67,639	$(14,355)	$53,284		

Table of Contents

We have determined that the unrealized losses of the securities on the watch list are temporary as we do not intend to sell these securities and it is more likely than not we will not have to sell these securities before recovery of their amortized cost. Our analysis of these securities and their credit performance at March 31, 2018 is as follows:
Corporate securities:
Consumer discretionary: The decline in the value of these securities, issued by a United States based toy manufacturer, relates to weak operating performance and sales trends and downgrades from all three main rating agencies. A portion of the decrease in sales is attributable to the liquidation of a major toy retailer during the fourth quarter of 2017. While the issuer has seen a decrease in operating performance, it has implemented a plan to reduce costs and stabilize its revenue and is in the early phase of executing on that plan. We have determined that these securities were not other than temporarily impaired due to our evaluation of the operating performance and the creditworthiness of the issuer and the fact that all required payments have been made.
Energy, Industrials and Materials: The decline in the value of these securities relates to continued operational pressure due to a decline in certain commodity prices specific to their businesses. The decline in these commodity prices creates financial challenges as the companies realign to accommodate the lower prices. These issuers will be stressed greater than the average company due to their price sensitivity and the specific position they hold in the supply chain. While values have declined, improving commodity prices have provided better financial performance for these companies. We recognized an other than temporary impairment on one security during the fourth quarter of 2017 and one security during the third quarter of 2016 due to our evaluation of the operating performance and the credit worthiness of the issuers. While the remaining issuers have seen their financial and profitability profile weakened, we have determined that the remaining securities were not other than temporarily impaired due to our evaluation of the operating performance and the credit worthiness of the issuer.
Other asset backed securities:
Financials: The decline in value of one of the asset backed securities is due to poor performance in the underlying pool of student loans. The investment is backed by a guarantee from the for-profit education services provider. We have determined that this security was not other than temporarily impaired, because all required payments have been made. The decline in value of the other asset backed security is related directly to the decline in oil prices and the financial stability of its operator. The issuer has direct exposure to the oil market as its primary business is deep water drilling. As oil prices have remained low, the operator of the deep water vessel has experienced financial pressure on its balance sheet. We recognized other than temporary impairments on this security during the second quarter of 2017, the second quarter of 2016 and the third quarter of 2015.
Other Than Temporary Impairments
We have a policy and process to identify securities in our investment portfolio for which we should recognize impairments. See Critical Accounting Policies—Evaluation of Other Than Temporary Impairments included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2017. During the three months ended March 31, 2018, we recognized an OTTI of $0.9 million on a corporate security issued by a Brazilian food company due to our intent to sell the security, which was in an unrealized loss position at the reporting date. During the three months ended March 31, 2017, we recognized additional credit losses on residential mortgage backed securities on which we have previously recognized OTTI.
Several factors led us to believe that full recovery of amortized cost is not expected on the securities for which we recognized credit losses and reclassified OTTI from accumulated other comprehensive income to net income. A discussion of these factors, our policy and process to identify securities that could potentially have impairment that is other than temporary and a summary of OTTI is presented in Note 3 to our unaudited consolidated financial statements in this Form 10-Q, which is incorporated by reference in this Item 2.
Mortgage Loans on Real Estate
Our commercial mortgage loan portfolio consists of 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. Our commercial mortgage loans on real estate are reported at cost, net of loan loss allowances and deferred prepayment fees. At March 31, 2018 and December 31, 2017, the largest principal amount outstanding for any single mortgage loan was

$23.9 million and $21.2 million, respectively, and the average loan size was $3.6 million and $3.5 million, respectively. In addition, the average loan to value ratio for the overall portfolio was 53.6% at both March 31, 2018 and December 31, 2017, respectively, based upon the underwriting and appraisal at the time the loan was made. This loan to value is indicative of our conservative underwriting policies and practices for making commercial mortgage loans and may not be indicative of collateral values at the current reporting date. Our current practice is to only obtain market value appraisals of the underlying collateral at the inception of the loan unless we identify indicators of impairment in our ongoing analysis of the portfolio, in which case, we either calculate a value of the collateral using a capitalization method or obtain a third party appraisal of the underlying collateral. The commercial mortgage loan portfolio is summarized by geographic region and property type in Note 4 to our unaudited consolidated financial statements in this Form 10-Q, incorporated by reference in this Item 2.

In the normal course of business, we commit to fund commercial mortgage loans up to 90 days in advance. At March 31, 2018, we had commitments to fund commercial mortgage loans totaling $51.7 million, with interest rates ranging from 4.41% to 6.64%. During 2018 and 2017, due to historically low interest rates, the commercial mortgage loan industry has been very competitive. This competition has resulted in a number of borrowers refinancing with other lenders. For the three months ended March 31, 2018, we received $42.4 million in cash for loans being paid in full compared to $49.8 million for the three months ended March 31, 2017. Some of the loans being paid off have either reached their maturity or are nearing maturity; however, some borrowers are paying the prepayment fee and refinancing at a lower rate.

45

Table of Contents

See Note 4 to our unaudited consolidated financial statements, incorporated by reference for a presentation of our specific and general loan loss allowances, impaired loans, foreclosure activity and troubled debt restructure analysis.
We have a process by which we evaluate the credit quality of each of our commercial mortgage loans. This process utilizes each loan's debt service coverage ratio as a primary metric. A summary of our portfolio by debt service coverage ratio (based on most recent information collected) follows:

	March 31, 2018		December 31, 2017	
	Principal Outstanding	Percent of Total Principal Outstanding	Principal Outstanding	Percent of Total Principal Outstanding
	(Dollars in thousands)			
Debt Service Coverage Ratio:				
Greater than or equal to 1.5	$1,854,662	68.5 %	$1,826,596	68.3 %
Greater than or equal to 1.2 and less than 1.5	647,165	23.9 %	638,299	23.9 %
Greater than or equal to 1.0 and less than 1.2	155,268	5.7 %	148,881	5.6 %
Less than 1.0	50,257	1.9 %	60,539	2.2 %
	$2,707,352	100.0 %	$2,674,315	100.0 %

Approximately 97% of our mortgage loans (based on principal outstanding) that have a debt service coverage ratio of less than 1.0 are performing under the original contractual loan terms at March 31, 2018.
Mortgage loans summarized in the following table represent all loans that we are either not currently collecting or those we feel it is probable we will not collect all amounts due according to the contractual terms of the loan agreements (all loans that we have worked with the borrower to alleviate short-term cash flow issues, loans delinquent for 60 days or more at the reporting date, loans we have determined to be collateral dependent and loans that we have recorded specific impairments on that we feel may continue to have performance issues).

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Impaired mortgage loans with an allowance	$3,186	$ 5,445
Impaired mortgage loans with no related allowance	1,395	1,436
Allowance for probable loan losses	(696)	(1,418)
Net carrying value of impaired mortgage loans	$3,885	$ 5,463

At March 31, 2018, we had no commercial mortgage loans that were delinquent (60 days or more past due at the reporting date) in their principal and interest payments.
Derivative Instruments
Our derivative instruments primarily consist of call options purchased to provide the income needed to fund the annual index credits on our fixed index annuity products. The fair value of the call options is based upon the amount of cash that would be required to settle the call options obtained from the counterparties adjusted for the nonperformance risk of the counterparty. The nonperformance risk for each counterparty is based upon its credit default swap rate. We have no performance obligations related to the call options.
None of our derivatives qualify for hedge accounting, thus, any change in the fair value of the derivatives that are not classified as equity is recognized immediately in the consolidated statements of operations. A presentation of our derivative instruments along with a discussion of the business strategy involved with our derivatives is included in Note 5 to our unaudited consolidated financial statements in this Form 10-Q, which is incorporated by reference in this Item 2.
Liquidity and Capital Resources
Our insurance subsidiaries continue to have adequate cash flows from annuity deposits and investment income to meet their policyholder and other obligations. Net cash flows from annuity deposits and funds returned to policyholders as surrenders, withdrawals and death claims were $275.3 million for the three months ended March 31, 2018 compared to $409.8 million for the three months ended March 31, 2017, with the decrease attributable to a $71.8 million

decrease in net annuity deposits after coinsurance and a $62.7 million (after coinsurance) increase in funds returned to policyholders. We continue to invest the net proceeds from policyholder transactions and investment activities in high quality fixed maturity securities and fixed rate commercial mortgage loans.

We, as the parent company, are a legal entity separate and distinct from our subsidiaries, and have no business operations. We need liquidity primarily to service our debt (senior notes and subordinated debentures issued to subsidiary trusts), pay operating expenses and pay dividends to stockholders. Our assets consist primarily of the capital stock and surplus notes of our subsidiaries. Accordingly, our future cash flows depend upon the availability of dividends, surplus note interest payments and other statutorily permissible payments from our subsidiaries, such as payments under our investment advisory agreements and tax allocation agreement with our subsidiaries. These sources provide adequate cash flow for us to meet our current and reasonably foreseeable future obligations.

Table of Contents

The ability of our life insurance subsidiaries to pay dividends or distributions, including surplus note payments, will be limited by applicable laws and regulations of the states in which our life insurance subsidiaries are domiciled, which subject our life insurance subsidiaries to significant regulatory restrictions. These laws and regulations require, among other things, our insurance subsidiaries to maintain minimum solvency requirements and limit the amount of dividends these subsidiaries can pay.

Currently, American Equity Life may pay dividends or make other distributions without the prior approval of the Iowa Insurance Commissioner, unless such payments, together with all other such payments within the preceding twelve months, exceed the greater of (1) American Equity Life's net gain from operations for the preceding calendar year, or (2) 10% of American Equity Life's statutory capital and surplus at the preceding December 31. For 2018, up to $377.1 million can be distributed as dividends by American Equity Life without prior approval of the Iowa Insurance Commissioner. In addition, dividends and surplus note payments may be made only out of statutory earned surplus, and all surplus note payments are subject to prior approval by regulatory authorities in the life subsidiary's state of domicile. American Equity Life had $1.8 billion of statutory earned surplus at March 31, 2018.

The maximum distribution permitted by law or contract is not necessarily indicative of an insurer's actual ability to pay such distributions, which may be constrained by business and regulatory considerations, such as the impact of such distributions on surplus, which could affect the insurer's ratings or competitive position, the amount of premiums that can be written and the ability to pay future dividends or make other distributions. Further, state insurance laws and regulations require that the statutory surplus of our life subsidiaries following any dividend or distribution must be reasonable in relation to their outstanding liabilities and adequate for their financial needs. Along with solvency regulations, the primary driver in determining the amount of capital used for dividends is the level of capital needed to maintain desired financial strength ratings from rating agencies. Both regulators and rating agencies could become more conservative in their methodology and criteria, including increasing capital requirements for our insurance subsidiaries which, in turn, could negatively affect the cash available to us from insurance subsidiaries. As of March 31, 2018, we estimate American Equity Life has sufficient statutory capital and surplus, combined with capital available to the holding company, to maintain this rating objective. However, this capital may not be sufficient if significant future losses are incurred or a rating agency modifies its rating criteria and access to additional capital could be limited.

The transfer of funds by American Equity Life is also restricted by a covenant in our line of credit agreement which requires American Equity Life to maintain a minimum RBC ratio of 275% and a minimum level of statutory surplus equal to the sum of 1) 80% of statutory surplus at June 30, 2016, 2) 50% of the statutory net income for each fiscal quarter ending after June 30, 2016, and 3) 50% of all capital contributed to American Equity Life after June 30, 2016. American Equity Life's RBC ratio was 378% at December 31, 2017. Under this agreement, we are also required to maintain a maximum ratio of adjusted debt to total adjusted capital of 0.35.

Cash and cash equivalents of the parent holding company at March 31, 2018, were $22.9 million. In addition, we have a $150 million revolving line of credit, with no borrowings outstanding, available through September 2021 for general corporate purposes of the parent company and its subsidiaries. We also have the ability to issue equity, debt or other types of securities through one or more methods of distribution under a currently effective shelf registration statement on Form S-3. The terms of any offering would be established at the time of the offering, subject to market conditions.

New Accounting Pronouncements

See Note 1 to our unaudited consolidated financial statements in this Form 10-Q, which is incorporated by reference in this Item 2.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We seek to invest our available funds in a manner that will maximize shareholder value and fund future obligations to policyholders and debtors, subject to appropriate risk considerations. We seek to meet this objective through investments that: (i) consist substantially of investment grade fixed maturity securities, (ii) have projected returns which satisfy our spread targets, and (iii) have characteristics which support the underlying liabilities. Many of our products incorporate surrender charges, market interest rate adjustments or other features to encourage persistency.

We seek to maximize the total return on our available for sale investments through active investment management. Accordingly, we have determined that our available for sale portfolio of fixed maturity securities is available to be

sold in response to: (i) changes in market interest rates, (ii) changes in relative values of individual securities and asset sectors, (iii) changes in prepayment risks, (iv) changes in credit quality outlook for certain securities, (v) liquidity needs, and (vi) other factors.
Interest rate risk is our primary market risk exposure. Substantial and sustained increases and decreases in market interest rates can affect the profitability of our products, the fair value of our investments, and the amount of interest we pay on our floating rate subordinated debentures. Our floating rate trust preferred securities bear interest at the three month LIBOR plus 3.50% - 4.00%. Our outstanding balance of floating rate trust preferred securities was $164.5 million at March 31, 2018, of which $85.5 million has been swapped to a fixed rate for seven years which began in March 2014 and $79.0 million has been capped for seven years which began in July 2014 (see Note 5 to our unaudited consolidated financial statements in this Form 10-Q). The profitability of most of our products depends on the spreads between interest yield on investments and rates credited on insurance liabilities. We have the ability to adjust crediting rates (caps, participation rates or asset fee rates for fixed index annuities) on substantially all of our annuity liabilities at least annually (subject to minimum guaranteed values). In addition, substantially all of our annuity products have surrender and withdrawal penalty provisions designed to encourage persistency and to help ensure targeted spreads are earned. However, competitive factors, including the impact of the level of surrenders and withdrawals, may limit our ability to adjust or maintain crediting rates at levels necessary to avoid narrowing of spreads under certain market conditions.

47

Table of Contents

A major component of our interest rate risk management program is structuring the investment portfolio with cash flow characteristics consistent with the cash flow characteristics of our insurance liabilities. We use models to simulate cash flows expected from our existing business under various interest rate scenarios. These simulations enable us to measure the potential gain or loss in fair value of our interest rate-sensitive financial instruments, to evaluate the adequacy of expected cash flows from our assets to meet the expected cash requirements of our liabilities and to determine if it is necessary to lengthen or shorten the average life and duration of our investment portfolio. The "duration" of a security is the time weighted present value of the security's expected cash flows and is used to measure a security's sensitivity to changes in interest rates. When the durations of assets and liabilities are similar, exposure to interest rate risk is minimized because a change in value of assets should be largely offset by a change in the value of liabilities.

If interest rates were to increase 10% (30 basis points) from levels at March 31, 2018, we estimate that the fair value of our fixed maturity securities would decrease by approximately $1.1 billion. The impact on stockholders' equity of such decrease (net of income taxes and certain adjustments for changes in amortization of deferred policy acquisition costs and deferred sales inducements) would be a decrease of $380.3 million in accumulated other comprehensive income and a decrease in stockholders' equity. The models used to estimate the impact of a 10% change in market interest rates incorporate numerous assumptions, require significant estimates and assume an immediate and parallel change in interest rates without any management of the investment portfolio in reaction to such change. Consequently, potential changes in value of our financial instruments indicated by the simulations will likely be different from the actual changes experienced under given interest rate scenarios, and the differences may be material. Because we actively manage our investments and liabilities, our net exposure to interest rates can vary over time. However, any such decreases in the fair value of our fixed maturity securities (unless related to credit concerns of the issuer requiring recognition of an other than temporary impairment) would generally be realized only if we were required to sell such securities at losses prior to their maturity to meet our liquidity needs, which we manage using the surrender and withdrawal provisions of our annuity contracts and through other means. See Financial Condition - Liquidity for Insurance Operations included in Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended December 31, 2017 for a further discussion of liquidity risk.

At March 31, 2018, 37% of our fixed income securities have call features, of which 2.7% ($1.2 billion) were subject to call redemption. Another 0.2% ($111.2 million) will become subject to call redemption during the next twelve months. Approximately 74% of our fixed income securities that have call features are not callable until within six months of their stated maturities. We have reinvestment risk related to these redemptions to the extent we cannot reinvest the net proceeds in assets with credit quality and yield characteristics similar to the redeemed bonds. Such reinvestment risk typically occurs in a declining rate environment. Should rates decline to levels which tighten the spread between our average portfolio yield and average cost of interest credited on annuity liabilities, we have the ability to reduce crediting rates (caps, participation rates or asset fees for fixed index annuities) on most of our annuity liabilities to maintain the spread at our targeted level. At March 31, 2018, approximately 99% of our annuity liabilities were subject to annual adjustment of the applicable crediting rates at our discretion, limited by minimum guaranteed crediting rates specified in the policies. At March 31, 2018, approximately 13% of our annuity liabilities were at minimum guaranteed crediting rates.

We purchase call options on the applicable indices to fund the annual index credits on our fixed index annuities. These options are primarily one-year instruments purchased to match the funding requirements of the underlying policies. Fair value changes associated with those investments are substantially offset by an increase or decrease in the amounts added to policyholder account balances for fixed index products. The difference between proceeds received at expiration of these options and index credits, as shown in the following table, is primarily due to over-hedging as a result of policyholder behavior being different than our expectations.

	Three Months Ended March 31,	
	2018	2017

	(Dollars in thousands)	
Annual index credits to policyholders on their anniversaries	$423,940	$321,880
Proceeds received at expiration of options related to such credits	425,557	326,552

On the anniversary dates of the index policies, we purchase new one-year call options to fund the next annual index credits. The risk associated with these prospective purchases is the uncertainty of the cost, which will determine whether we are able to earn our spread on our index business. We manage this risk through the terms of our fixed index annuities, which permit us to change caps, participation rates and asset fees, subject to contractual features. By modifying caps, participation rates or asset fees, we can limit option costs to budgeted amounts, except in cases where the contractual features would prevent further modifications. Based upon actuarial testing which we conduct as a part of the design of our index products and on an ongoing basis, we believe the risk that contractual features would prevent us from controlling option costs is not material.

Table of Contents

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

In accordance with the Securities Exchange Act Rules 13a-15(e) and 15d-15(e), our management, under the supervision of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures were effective as of March 31, 2018 in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

There were no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See Note 7 - Commitments and Contingencies to the unaudited consolidated financial statements in this Form 10-Q, which is incorporated by reference in this Item 1, for litigation and regulatory disclosures.

Item 1A. Risk Factors

Our 2017 Annual Report on Form 10-K described our Risk Factors. There have been no material changes to the Risk Factors during the three months ended March 31, 2018.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Securities

The following table presents the amount of our share purchase activity for the periods indicated:

Period	Total Number of Shares Purchased (a)	Average Price Paid Per Share
January 1, 2018 - January 31, 2018	—	$ —
February 1, 2018 - February 28, 2018	913	$ 31.92
March 1, 2018 - March 31, 2018	8,759	$ 31.82
Total	9,672	

(a) Includes the number of shares of common stock utilized to execute certain stock incentive awards.

Table of Contents

Item 6. Exhibits

Exhibit No.	Description	Method of Filing
10.1	Form of Restricted Stock Unit Award Agreement	Filed herewith
10.2	Form of Director Stock Option Agreement	Filed herewith
10.3	Form of Employee Stock Option Agreement	Filed herewith
10.4	Form of Employee Stock Option Agreement	Filed herewith
10.5	Form of Change in Control Agreement between American Equity Investment Life Holding Company and Jennifer L. Bryant	Filed herewith
12.1	Ratio of Earnings to Fixed Charges	Filed herewith
31.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
101.INS	XBRL Instance Document	Filed herewith
101.SCH	XBRL Taxonomy Extension Schema Document	Filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	Filed herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	Filed herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	Filed herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	Filed herewith

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 8, 2018 AMERICAN EQUITY INVESTMENT LIFE HOLDING COMPANY

By: /s/ John M. Matovina
John M. Matovina, Chief Executive Officer and President
(Principal Executive Officer)

By: /s/ Ted M. Johnson
Ted M. Johnson, Chief Financial Officer and Treasurer
(Principal Financial Officer)

By: /s/ Scott A. Samuelson
Scott A. Samuelson, Vice President and Chief Accounting Officer
(Principal Accounting Officer)

51