Hilltop Holdings Inc.
Form 10-Q
May 05, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2014

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

Commission File Number: 1-31987

Hilltop Holdings Inc.

(Exact name of registrant as specified in its charter)

Maryland	**84-1477939**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

200 Crescent Court, Suite 1330

Dallas, TX	**75201**
(Address of principal executive offices)	(Zip Code)

(214) 855-2177

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or 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 x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares of the registrant s common stock outstanding at May 2, 2014 was 90,180,699.

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HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2014

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	March 31, 2014 (Unaudited)	December 31, 2013
Assets		
Cash and due from banks	$ 889,950	$ 713,099
Federal funds sold and securities purchased under agreements to resell	27,460	32,924
Securities:		
Trading, at fair value	53,350	58,846
Available for sale, at fair value (amortized cost of $1,270,685 and $1,256,862, respectively)	1,245,359	1,203,143
Held to maturity, at amortized cost (fair value of $30,902)	30,981	
	1,329,690	1,261,989
Loans held for sale	887,200	1,089,039
Non-covered loans, net of unearned income	3,646,946	3,514,646
Allowance for non-covered loan losses	(34,645)	(33,241)
Non-covered loans, net	3,612,301	3,481,405
Covered loans, net of allowance of $2,665 and $1,061, respectively	909,783	1,005,308
Broker-dealer and clearing organization receivables	174,442	119,317
Insurance premiums receivable	26,234	25,597
Deferred policy acquisition costs	21,096	20,991
Premises and equipment, net	202,155	200,706
FDIC indemnification asset	188,736	188,291
Covered other real estate owned	152,310	142,833
Mortgage servicing rights	29,939	20,149
Other assets	262,220	279,745
Goodwill	251,808	251,808
Other intangible assets, net	68,108	70,921
Total assets	$ 9,033,432	$ 8,904,122
Liabilities and Stockholders Equity		
Deposits:		
Noninterest-bearing	$ 1,748,391	$ 1,773,749
Interest-bearing	4,914,785	4,949,169
Total deposits	6,663,176	6,722,918
Broker-dealer and clearing organization payables	161,888	129,678
Reserve for losses and loss adjustment expenses	28,258	27,468
Unearned insurance premiums	89,646	88,422
Short-term borrowings	491,406	342,087
Notes payable	55,465	56,327
Junior subordinated debentures	67,012	67,012
Other liabilities	121,368	158,288
Total liabilities	7,678,219	7,592,200
Commitments and contingencies (see Notes 11 and 12)		
Stockholders equity:		
Hilltop stockholders equity:		
	114,068	114,068

Preferred stock, $0.01 par value, 10,000,000 shares authorized; Series B, liquidation value per share of $1,000; 114,068 shares issued and outstanding				
Common stock, $0.01 par value, 100,000,000 shares authorized; 90,177,991 and 90,175,688 shares issued and outstanding, respectively		902		902
Additional paid-in capital		1,388,002		1,388,641
Accumulated other comprehensive loss		(16,054)		(34,863)
Accumulated deficit		(132,421)		(157,607)
Total Hilltop stockholders equity		1,354,497		1,311,141
Noncontrolling interest		716		781
Total stockholders equity		1,355,213		1,311,922
Total liabilities and stockholders equity	$	9,033,432	$	8,904,122

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three Months Ended March 31, 2014	2013
Interest income:		
Loans, including fees	$ 79,744	$ 64,886
Securities:		
Taxable	7,588	5,912
Tax-exempt	1,242	1,347
Federal funds sold and securities purchased under agreements to resell	19	21
Interest-bearing deposits with banks	595	333
Other	2,640	2,105
Total interest income	91,828	74,604
Interest expense:		
Deposits	3,759	3,450
Short-term borrowings	395	513
Notes payable	648	2,322
Junior subordinated debentures	584	608
Other	1,021	450
Total interest expense	6,407	7,343
Net interest income	85,421	67,261
Provision for loan losses	3,242	13,005
Net interest income after provision for loan losses	82,179	54,256
Noninterest income:		
Net gains from sale of loans and other mortgage production income	79,111	127,596
Mortgage loan origination fees	12,344	18,893
Net insurance premiums earned	40,319	37,473
Investment and securities advisory fees and commissions	21,335	22,009
Other	16,991	7,307
Total noninterest income	170,100	213,278
Noninterest expense:		
Employees compensation and benefits	106,429	116,190
Loss and loss adjustment expenses	18,337	21,185
Policy acquisition and other underwriting expenses	11,687	10,803
Occupancy and equipment, net	26,338	19,412
Other	49,838	47,401
Total noninterest expense	212,629	214,991
Income before income taxes	39,650	52,543
Income tax expense	14,354	19,170
Net income	25,296	33,373
Less: Net income attributable to noncontrolling interest	110	300

Income attributable to Hilltop		25,186		33,073
Dividends on preferred stock		1,426		703
Income applicable to Hilltop common stockholders	$	23,760	$	32,370
Earnings per common share:				
Basic	$	0.26	$	0.39
Diluted	$	0.26	$	0.39
Weighted average share information:				
Basic		89,707		83,487
Diluted		90,585		83,743

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Net income	$ 25,296	$ 33,373
Other comprehensive income:		
Unrealized gains on securities available for sale, net of tax of $9,583 and $473	18,809	879
Comprehensive income	44,105	34,252
Less: comprehensive income attributable to noncontrolling interest	110	300
Comprehensive income applicable to Hilltop	$ 43,995	$ 33,952

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands)

(Unaudited)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Hilltop Stockholders Equity	Noncontrolling Interest	Total Stockholders Equity
Balance, December 31, 2012	114	$ 114,068	83,487	$ 835	$ 1,304,448	$ 8,094	$ (282,949)	$ 1,144,496	$ 2,054	$ 1,146,550
Net income							33,073	33,073	300	33,373
Other comprehensive income						879		879		879
Stock-based compensation expense					64			64		64
Dividends on preferred stock					(703)			(703)		(703)
Cash distributions to noncontrolling interest									(1,578)	(1,578)
Balance, March 31, 2013	114	$ 114,068	83,487	$ 835	$ 1,303,809	$ 8,973	$ (249,876)	$ 1,177,809	$ 776	$ 1,178,585
Balance, December 31, 2013	114	$ 114,068	90,176	$ 902	$ 1,388,641	$ (34,863)	$ (157,607)	$ 1,311,141	$ 781	$ 1,311,922
Net income							25,186	25,186	110	25,296
Other comprehensive income						18,809		18,809		18,809
Stock-based compensation expense					735			735		735
Common stock issued to board members			2		52			52		52
Dividends on preferred stock					(1,426)			(1,426)		(1,426)
Cash distributions to noncontrolling interest									(175)	(175)
Balance, March 31, 2014	114	$ 114,068	90,178	$ 902	$ 1,388,002	$ (16,054)	$ (132,421)	$ 1,354,497	$ 716	$ 1,355,213

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Three Months Ended March 31, 2014	2013
Operating Activities		
Net income	$ 25,296	$ 33,373
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	3,242	13,005
Depreciation, amortization and accretion, net	(20,615)	(9,548)
Deferred income taxes	4,878	(7,067)
Other, net	1,435	85
Net change in securities purchased under resale agreements		(3,254)
Net change in trading securities	5,496	29,344
Net change in broker-dealer and clearing organization receivables	(88,613)	(77,077)
Net change in other assets	454	47,641
Net change in broker-dealer and clearing organization payables	62,842	34,075
Net change in loss and loss adjustment expense reserve	790	(1,942)
Net change in unearned insurance premiums	1,224	1,434
Net change in other liabilities	(36,773)	(56,899)
Net gains from sale of loans	(79,111)	(127,596)
Loans originated for sale	(1,954,133)	(3,025,709)
Proceeds from loans sold	2,227,917	3,310,115
Net cash provided by operating activities	154,329	159,980
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	351	
Proceeds from sales, maturities and principal reductions of securities available for sale	31,845	53,759
Purchases of securities held to maturity	(31,334)	
Purchases of securities available for sale	(46,024)	(209,507)
Net change in loans	(256)	(41,872)
Purchases of premises and equipment and other assets	(8,710)	(5,041)
Proceeds from sales of premises and equipment and other real estate owned	14,713	3,880
Net cash received for Federal Home Loan Bank and Federal Reserve Bank stock		6,702
Net cash used in investing activities	(39,415)	(192,079)
Financing Activities		
Net change in deposits	(90,374)	68,869
Net change in short-term borrowings	149,319	(151,520)
Payments on notes payable	(862)	(792)
Dividends paid on preferred stock	(1,342)	
Net cash distributed to noncontrolling interest	(175)	(1,578)
Other, net	(93)	(65)
Net cash provided by (used in) financing activities	56,473	(85,086)
Net change in cash and cash equivalents	171,387	(117,185)
Cash and cash equivalents, beginning of period	746,023	726,460
Cash and cash equivalents, end of period	$ 917,410	$ 609,275

Supplemental Disclosures of Cash Flow Information				
Cash paid for interest	$	6,934	$	8,313
Cash paid for income taxes, net of refunds	$	(1,845)	$	2,205
Supplemental Schedule of Non-Cash Activities				
Conversion of loans to other real estate owned	$	25,588	$	284

See accompanying notes.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

1. Summary of Significant Accounting and Reporting Policies

Nature of Operations

Hilltop Holdings Inc. (Hilltop and, collectively with its subsidiaries, the Company) is a financial holding company registered under the Bank Holding Company Act of 1956, as amended by the Gramm-Leach-Bliley Act of 1999. On November 30, 2012, Hilltop acquired PlainsCapital Corporation pursuant to a plan of merger whereby PlainsCapital Corporation merged with and into a wholly owned subsidiary of Hilltop (the PlainsCapital Merger), which continued as the surviving entity under the name PlainsCapital Corporation (PlainsCapital).

The Company has two primary operating business units, PlainsCapital and National Lloyds Corporation (NLC). PlainsCapital is a financial holding company, headquartered in Dallas, Texas, that provides, through its subsidiaries, an array of financial products and services. In addition to traditional banking services, PlainsCapital provides residential mortgage lending, investment banking, public finance advisory, wealth and investment management, treasury management, capital equipment leasing, fixed income sales, asset management, and correspondent clearing services. NLC is a property and casualty insurance holding company that provides, through its subsidiaries, fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the southern United States.

On September 13, 2013 (the Bank Closing Date), PlainsCapital Bank (the Bank) assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of Edinburg, Texas-based First National Bank (FNB) from the Federal Deposit Insurance Corporation (the FDIC), as receiver, and reopened former FNB branches acquired from the FDIC under the PlainsCapital Bank name (the FNB Transaction). Pursuant to the Purchase and Assumption Agreement (the P&A Agreement), the Bank and the FDIC entered into loss-share agreements whereby the FDIC agreed to share in the losses of certain covered loans and covered other real estate owned (OREO) that the Bank acquired, as further described in Note 2 to the consolidated financial statements. The fair value of the assets acquired was $2.2 billion, including $1.1 billion in covered loans, $286.2 million in securities, $135.2 million in covered OREO and $42.9 million in non-covered loans. The Bank also assumed $2.2 billion in liabilities, consisting primarily of deposits. The acquisition of FNB s expansive branch network allowed the Bank to increase its presence in Texas to include the Rio Grande Valley, Houston, Corpus Christi, Laredo and El Paso markets, among others.

On March 31, 2014, the Company entered into a definitive merger agreement with SWS Group, Inc. (SWS) providing for the merger of SWS with and into a wholly owned subsidiary of Hilltop formed for the purpose of facilitating this transaction. SWS stockholders will receive per share consideration of 0.2496 shares of Hilltop common stock and $1.94 of cash, equating to $7.88 per share based on Hilltop s closing price on March 31, 2014. The Company intends to fund the cash portion of the consideration through available cash. The merger is subject to customary closing conditions, including regulatory approvals and approval of the stockholders of SWS, and is expected to be completed prior to the end of 2014.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States (GAAP), and in conformity with the rules and regulations of the Securities and Exchange Commission (the SEC). In the opinion of management, these financial statements contain all adjustments necessary for a fair statement of the results of the interim periods presented. Accordingly, the financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013. Results for interim periods are not necessarily indicative of results to be expected for a full year or any future period.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates regarding the allowance for loan losses, the fair values of financial instruments, the amounts receivable under the loss-share agreements with the FDIC (FDIC Indemnification Asset), reserves for losses and loss adjustment expenses, the mortgage loan indemnification liability, and the potential impairment of assets are particularly subject to change. The Company has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.

Certain reclassifications have been made to the prior period consolidated financial statements to conform with the current period presentation. In addition, the Company revised its historical consolidated balance sheets to correct the classification of certain noninterest-bearing deposits. The correction resulted in an increase in noninterest-bearing deposits and a decrease in interest-bearing deposits of $1.3 billion and $1.0 billion at December 31, 2013 and 2012, respectively, and the correction of the deposits note to the consolidated financial statements. Management has evaluated the impact of the correction as immaterial to previously issued financial statements; however, has elected to revise such amounts in the accompanying consolidated financial statements. The Company will similarly revise the consolidated balance sheets and deposits note to the quarterly and annual consolidated financial statements in its future filings.

Hilltop owns 100% of the outstanding stock of PlainsCapital. PlainsCapital owns 100% of the outstanding stock of the Bank and 100% of the membership interest in PlainsCapital Equity, LLC. The Bank owns 100% of the outstanding stock of PrimeLending, a PlainsCapital Company (PrimeLending) and PCB-ARC, Inc. The Bank has a 100% membership interest in First Southwest Holdings, LLC (First Southwest) and PlainsCapital Securities, LLC, as well as a 51% voting interest in PlainsCapital Insurance Services, LLC.

Hilltop also owns 100% of NLC, which operates through its wholly owned subsidiaries, National Lloyds Insurance Company (NLIC) and American Summit Insurance Company (ASIC).

PrimeLending owns a 100% membership interest in PrimeLending Ventures Management, LLC, the controlling and sole managing member of PrimeLending Ventures, LLC (Ventures).

The principal subsidiaries of First Southwest are First Southwest Company (FSC), a broker-dealer registered with the SEC and the Financial Industry Regulatory Authority, and First Southwest Asset Management, Inc., a registered investment advisor under the Investment Advisors Act of 1940.

The consolidated financial statements include the accounts of the above-named entities. All significant intercompany transactions and balances have been eliminated. Noncontrolling interests have been recorded for minority ownership in entities that are not wholly owned and are presented in compliance with the provisions of Noncontrolling Interest in Subsidiary Subsections of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC).

PlainsCapital also owns 100% of the outstanding common securities of PCC Statutory Trusts I, II, III and IV (the Trusts), which are not included in the consolidated financial statements under the requirements of the Variable Interest Entities Subsections of the ASC, because the primary beneficiaries of the Trusts are not within the consolidated group.

2. Acquisitions

FNB Transaction

On the Bank Closing Date, the Bank assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of FNB from the FDIC in an FDIC-assisted transaction. As part of the P&A Agreement, the Bank and the FDIC entered into loss-share agreements covering future losses incurred on certain acquired loans and OREO. The Company refers to acquired commercial and single family residential loan portfolios and OREO that are subject to the loss-share agreements as covered loans and covered OREO , respectively, and these assets are presented as separate line items in the Company s consolidated balance sheet. Collectively, covered loans and covered OREO are referred to as covered assets .

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

In accordance with the loss-share agreements, the Bank may be required to make a true-up payment to the FDIC approximately ten years following the Bank Closing Date if the FDIC s initial estimate of losses on covered assets is greater than the actual realized losses. The true-up payment is calculated using a defined formula set forth in the P&A Agreement.

The FNB Transaction was accounted for using the purchase method of accounting and, accordingly, purchased assets, including identifiable intangible assets and assumed liabilities, were recorded at their respective fair values as of the Bank Closing Date using significant estimates and assumptions to value certain identifiable assets acquired and liabilities assumed. The amounts are subject to adjustments based upon final settlement with the FDIC. The terms of the P&A Agreement provide for the FDIC to indemnify the Bank against claims with respect to liabilities and assets of FNB or any of its affiliates not assumed or otherwise purchased by the Bank and with respect to certain other claims by third parties.

Pro Forma Results of Operations

The operations acquired in the FNB Transaction are included in the Company s operating results beginning September 14, 2013. The purchase of assets and assumption of certain liabilities of FNB from the FDIC, as receiver, was sufficiently significant to require disclosure of historical financial statements and related pro forma financial disclosure. Due to the nature and magnitude of the FNB Transaction, coupled with the federal assistance and protection resulting from the FDIC loss-share agreements, historical financial information of FNB is not relevant to future operations. The Company has omitted certain historical financial information and the related pro forma financial information of FNB pursuant to the guidance provided in Staff Accounting Bulletin Topic 1.K, Financial Statements of Acquired Troubled Financial Institutions (SAB 1:K), and a request for relief granted by the SEC. SAB 1:K provides relief from the requirements of Rule 3-05 of Regulation S-X in certain instances, such as the FNB Transaction, where a registrant engages in an acquisition of a significant amount of assets of a troubled financial institution for which audited financial statements are not reasonably available and in which federal assistance is so persuasive as to substantially reduce the relevance of such information to an assessment of future operations.

3. Fair Value Measurements

Fair Value Measurements and Disclosures

The Company determines fair values in compliance with The Fair Value Measurements and Disclosures Topic of the ASC (the Fair Value Topic). The Fair Value Topic defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. The Fair Value Topic defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The Fair Value Topic assumes that transactions upon which fair value measurements are based occur in the principal market for the asset or liability being measured. Further, fair value measurements made under the Fair Value Topic exclude transaction costs and are not the result of forced transactions.

The Fair Value Topic creates a fair value hierarchy that classifies fair value measurements based upon the inputs used in valuing the assets or liabilities that are the subject of fair value measurements. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs, as indicated below.

- *Level 1 Inputs*: Unadjusted quoted prices in active markets for identical assets or liabilities that the Company can access at the measurement date.

- *Level 2 Inputs*: Observable inputs other than Level 1 prices. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates, yield curves, prepayment speeds, default rates, credit risks, loss severities, etc.), and inputs that are derived from or corroborated by market data, among others.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

- *Level 3 Inputs*: Unobservable inputs that reflect an entity s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities. Level 3 inputs include pricing models and discounted cash flow techniques, among others.

Fair Value Option

The Company has elected to measure substantially all of PrimeLending s mortgage loans held for sale and retained mortgage servicing rights (MSR) at fair value, and certain time deposits at the Bank under the provisions of the Fair Value Option. The Company elected to apply the provisions of the Fair Value Option to these items so that it would have the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The Company determines the fair value of the financial instruments accounted for under the provisions of the Fair Value Option in compliance with the provisions of the Fair Value Topic of the ASC discussed above.

At March 31, 2014, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option was $886.6 million, and the unpaid principal balance of those loans was $860.5 million. At December 31, 2013, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option was $1.09 billion, and the unpaid principal balance of those loans was $1.07 billion. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

The Company holds a number of financial instruments that are measured at fair value on a recurring basis, either by the application of the Fair Value Option or other authoritative pronouncements. The fair values of those instruments are determined primarily using Level 2 inputs. Those inputs include quotes from mortgage loan investors and derivatives dealers, data from independent pricing services and rates paid in the brokered certificate of deposit market.

The following tables present information regarding financial assets and liabilities measured at fair value on a recurring basis (in thousands).

March 31, 2014	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total Fair Value**
Trading securities	$ 33	$ 53,317	$	$ 53,350
Available for sale securities	24,663	1,156,598	64,098	1,245,359
Loans held for sale		860,374	26,826	887,200
Derivative assets		23,365		23,365
Mortgage servicing rights asset			29,939	29,939
Trading liabilities		48		48

Derivative liabilities			5,950	5,950

December 31, 2013	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Trading securities	33	58,813	$	58,846
Available for sale securities	22,079	1,121,011	60,053	1,203,143
Loans held for sale		1,061,310	27,729	1,089,039
Derivative assets		23,564		23,564
Mortgage servicing rights asset			20,149	20,149
Trading liabilities		46		46
Derivative liabilities		139	5,600	5,739

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables include a roll forward for those financial instruments measured at fair value using Level 3 inputs (in thousands).

	Balance at Beginning of Period	Purchases/ Additions	Sales/ Reductions	Total Gains or Losses (Realized or Unrealized) Included in Net Income	Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended March 31, 2014						
Available for sale securities	$ 60,053	$	$	$ 593	$ 3,452	$ 64,098
Loans held for sale	27,729	4,900	(5,594)	(209)		26,826
Mortgage servicing rights asset	20,149	7,432		2,358		29,939
Derivative liabilities	(5,600)			(350)		(5,950)
Total	$ 102,331	$ 12,332	$ (5,594)	$ 2,392	$ 3,452	$ 114,913
Three months ended March 31, 2013						
Available for sale securities	$ 56,277	$	$	$ 512	$ 2,012	$ 58,801
Mortgage servicing rights asset	2,080	2,125		225		4,430
Derivative liabilities	(4,490)			(224)		(4,714)
Total	$ 53,867	$ 2,125	$	$ 513	$ 2,012	$ 58,517

All net unrealized gains (losses) in the tables above are reflected in the accompanying consolidated financial statements. The unrealized gains (losses) relate to financial instruments still held at March 31, 2014. The available for sale securities noted in the table above reflect Hilltop s note receivable and warrant to purchase common stock of SWS as discussed in Note 4 to the consolidated financial statements.

Hilltop s note receivable is valued using a cash flow model that estimates yield based on comparable securities in the market. The interest rate used to discount cash flows is the most significant unobservable input. An increase or decrease in the discount rate would result in a corresponding decrease or increase, respectively, in the fair value measurement of the note receivable.

The warrant is valued utilizing a binomial model. The underlying SWS common stock price and its related volatility, an unobservable input, are the most significant inputs into the model, and, therefore, decreases or increases to the SWS common stock price would result in a significant change in the fair value measurement of the warrant.

Loans held for sale, including monitored mortgage loans, are valued using commitments on hand from investors or prevailing market prices.

The MSR asset is valued by projecting net servicing cash flows, which are then discounted to estimate the fair value. The fair value of the MSR asset is impacted by a variety of factors, including prepayment assumptions, discount rates, delinquency rates, contractually specified servicing fees, servicing costs and underlying portfolio characteristics.

Derivative liabilities in the tables above include a derivative option agreement (Fee Award Option) entered into by First Southwest and valued using discounted cash flows and probability of exercise.

The Company had no transfers between Levels 1 and 2 during the periods presented.

The following table presents the changes in fair value for instruments that are reported at fair value under the Fair Value Option (in thousands).

	Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option					
	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	$ 4,518	$	$ 4,518	$ (5,438)	$	$ (5,438)
Mortgage servicing rights asset	2,358		2,358	225		225
Time deposits					8	8

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The Company also determines the fair value of certain assets and liabilities on a non-recurring basis. In addition, facts and circumstances may dictate a fair value measurement when there is evidence of impairment. Assets and liabilities measured on a non-recurring basis include the items discussed below.

Impaired Loans The Company reports impaired loans based on the underlying fair value of the collateral through specific allowances within the allowance for loan losses. Purchased credit impaired (PCI) loans with a fair value of $172.9 million and $822.8 million were acquired by the Company upon completion of the PlainsCapital Merger and the FNB Transaction, respectively. Substantially all PCI loans acquired in the FNB Transaction are covered by FDIC loss-share agreements. The fair value of PCI loans was determined using Level 3 inputs, including estimates of expected cash flows that incorporated assumptions regarding default rates, loss severity rates assuming default, prepayment speeds and estimated collateral values.

Other Real Estate Owned The Company reports OREO at fair value less estimated cost to sell. Any excess of recorded investment over fair value, less cost to sell, is charged against the allowance for loan losses when property is initially transferred to OREO. Subsequent to the initial transfer to OREO, downward valuation adjustments are charged against earnings. The Company determines fair value primarily using independent appraisals of OREO properties. The resulting fair value measurements are classified as Level 2 or Level 3 inputs, depending upon the extent to which unobservable inputs determine the fair value measurement. The Company considers a number of factors in determining the extent to which specific fair value measurements utilize unobservable inputs, including, but not limited to, the inherent subjectivity in appraisals, the length of time elapsed since the receipt of independent market price or appraised value, and current market conditions. In the FNB Transaction, the Bank acquired OREO of $135.2 million, all of which is covered by FDIC loss-share agreements. At March 31, 2014 and December 31, 2013, the estimated fair value of covered OREO was $152.3 million and $142.8 million, respectively, and the underlying fair value measurements utilize Level 3 inputs. The fair value of non-covered OREO at March 31, 2014 and December 31, 2013 was $5.8 million and $4.8 million, respectively, and is included in other assets within the consolidated balance sheets. During the reported periods, all fair value measurements for non-covered OREO utilized Level 2 inputs.

The following table presents information regarding certain assets and liabilities measured at fair value on a non-recurring basis for which a change in fair value has been recorded during reporting periods subsequent to initial recognition (in thousands).

March 31, 2014	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value	Total Gains (Losses) for the Three Months Ended March 31, 2014	Total Gains (Losses) for the Three Months Ended March 31, 2013
Non-covered impaired loans	$	$	$ 29,043	$ 29,043	$ (215)	$ (431)
Covered impaired loans			35,519	35,519	(1,691)	
Non-covered other real estate owned		18		18	(102)	(160)
Covered other real estate owned			34,167	34,167	(431)	

The Fair Value of Financial Instruments Subsection of the ASC requires disclosure of the fair value of financial assets and liabilities, including the financial assets and liabilities previously discussed. The methods for determining estimated fair value for financial assets and liabilities is described in detail in Note 3 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables present the carrying values and estimated fair values of financial instruments not measured at fair value on either a recurring or non-recurring basis (in thousands).

		Estimated Fair Value			
March 31, 2014	**Carrying Amount**	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total**
Financial assets:					
Cash and cash equivalents	$ 917,410	$ 917,410	$	$	$ 917,410
Held to maturity securities	30,981		30,902		30,902
Non-covered loans, net	3,612,301		315,199	3,313,626	3,628,825
Covered loans, net	909,783			1,060,417	1,060,417
Broker-dealer and clearing organization receivables	174,442		174,442		174,442
FDIC indemnification asset	188,736			188,736	188,736
Other assets	64,178		42,233	21,945	64,178
Financial liabilities:					
Deposits	6,663,176		6,667,621		6,667,621
Broker-dealer and clearing organization payables	161,888		161,888		161,888
Short-term borrowings	491,406		491,406		491,406
Debt	122,477		115,777		115,777
Other liabilities	2,834		2,834		2,834

		Estimated Fair Value			
December 31, 2013	**Carrying Amount**	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total**
Financial assets:					
Cash and cash equivalents	$ 746,023	$ 746,023	$	$	$ 746,023
Non-covered loans, net	3,481,405		281,712	3,119,319	3,401,031
Covered loans, net	1,005,308			997,371	997,371
Broker-dealer and clearing organization receivables	119,317		119,317		119,317
FDIC indemnification asset	188,291			188,291	188,291
Other assets	66,055		43,946	22,109	66,055
Financial liabilities:					
Deposits	6,722,019		6,722,909		6,722,909
Broker-dealer and clearing organization payables	129,678		129,678		129,678
Short-term borrowings	342,087		342,087		342,087
Debt	123,339		114,671		114,671
Other liabilities	3,362		3,362		3,362

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

4. Securities

The amortized cost and fair value of securities, excluding trading securities, are summarized as follows (in thousands).

	Available for Sale			
March 31, 2014	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Treasury securities	$ 63,684	$ 80	$ (94)	$ 63,670
U.S. government agencies:				
Bonds	704,980	1,051	(38,903)	667,128
Residential mortgage-backed securities	57,781	1,269	(505)	58,545
Collateralized mortgage obligations	117,336	296	(3,800)	113,832
Corporate debt securities	95,422	4,955	(226)	100,151
States and political subdivisions	155,292	843	(3,550)	152,585
Commercial mortgage-backed securities	618	69		687
Equity securities	20,237	4,426		24,663
Note receivable	43,267	5,315		48,582
Warrant	12,068	3,448		15,516
Totals	$ 1,270,685	$ 21,752	$ (47,078)	$ 1,245,359

	Available for Sale			
December 31, 2013	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
U.S. Treasury securities	$ 43,684	$ 82	$ (238)	$ 43,528
U.S. government agencies:				
Bonds	717,909	550	(55,727)	662,732
Residential mortgage-backed securities	59,936	735	(584)	60,087
Collateralized mortgage obligations	124,502	349	(4,390)	120,461
Corporate debt securities	72,376	4,610	(378)	76,608
States and political subdivisions	162,955	388	(6,508)	156,835
Commercial mortgage-backed securities	691	69		760
Equity securities	20,067	2,012		22,079
Note receivable	42,674	5,235		47,909
Warrant	12,068	76		12,144
Totals	$ 1,256,862	$ 14,106	$ (67,825)	$ 1,203,143

	Held to Maturity			
March 31, 2014	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
U.S. government agencies:				

Residential mortgage-backed securities	$	29,582	$		$	(70)	$	29,512
States and political subdivisions		1,399		1		(10)		1,390
Totals	$	30,981	$	1	$	(80)	$	30,902

Available for sale securities includes 1,475,387 shares of SWS common stock, a $50.0 million aggregate principal amount note issued by SWS and a warrant to purchase 8,695,652 shares of SWS common stock. SWS issued the note in July 2011 under a credit agreement pursuant to a senior unsecured loan from Hilltop. The note bears interest at a rate of 8.0% per annum, is prepayable by SWS subject to certain conditions after three years, and has a maturity of five years. The warrant provides for the purchase of 8,695,652 shares of SWS common stock at an exercise price of $5.75 per share, subject to anti-dilution adjustments. If the warrant was fully exercised, Hilltop would beneficially own 24.4% of SWS.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Information regarding securities that were in an unrealized loss position is shown in the following tables (dollars in thousands).

[redacted]

`	March 31, 2014			December 31, 2013		
	Number of		Unrealized	Number of		Unrealized
Available for Sale						
U.S. treasury securities:						
Unrealized loss for less than twelve months	6	$ 13,289	$ 94	6	$ 12,748	$ 238
Unrealized loss for twelve months or longer						
	6	13,289	94	6	12,748	238
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	31	399,291	24,490	35	526,817	45,274
Unrealized loss for twelve months or longer	7	160,352	14,413	5	90,931	10,453
	38	559,643	38,903	40	617,748	55,727
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	1	1,595	62	2	2,194	54
Unrealized loss for twelve months or longer	3	9,325	443	3	9,309	530
	4	10,920	505	5	11,503	584
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	6	68,200	3,740	7	84,054	4,320
Unrealized loss for twelve months or longer	2	4,095	60	2	4,995	70
	8	72,295	3,800	9	89,049	4,390
Corporate debt securities:						
Unrealized loss for less than twelve months	7	10,732	226	7	10,754	378
Unrealized loss for twelve months or longer						
	7	10,732	226	7	10,754	378
States and political subdivisions:						
Unrealized loss for less than twelve months	29	21,753	257	46	30,245	669
Unrealized loss for twelve months or longer	140	92,954	3,293	150	96,882	5,839
	169	114,707	3,550	196	127,127	6,508
Total available for sale:						
Unrealized loss for less than twelve months	80	514,860	28,869	103	666,812	50,933
Unrealized loss for twelve months or longer	152	266,726	18,209	160	202,117	16,892
	232	$ 781,586	$ 47,078	263	$ 868,929	$ 67,825

	Securities	Fair Value	Losses	Securities	Fair Value	Losses
Held to Maturity						
U.S. government agencies:						
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	3	$ 29,512	$ 70	$	$	$
Unrealized loss for twelve months or longer						
	3	29,512	70			
States and political subdivisions:						
Unrealized loss for less than twelve months	2	1,112	10			
Unrealized loss for twelve months or longer						
	2	1,112	10			
Total held to maturity:						
Unrealized loss for less than twelve months	5	30,624	80			
Unrealized loss for twelve months or longer						
	5	$ 30,624	$ 80		$	$

During the three months ended March 31, 2014 and 2013, the Company did not record any other-than-temporary impairments. While all of the investments are monitored for potential other-than-temporary impairment, the Company s analysis and experience indicate that these available for sale investments generally do not present a great risk of other-than-temporary-impairment, as fair value should recover over time. Factors considered in the Company s analysis include the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted performance of the investee. While some of the securities held in the investment portfolio have decreased in value since the date of acquisition, the severity of loss and the duration of the loss position are not believed to be

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significant enough to warrant other-than-temporary impairment of the securities. The Company does not intend, nor is it likely that the Company will be required, to sell these securities before the recovery of the cost basis. Therefore, management does not believe any other-than-temporary impairments exist at March 31, 2014.

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The amortized cost and fair value of securities, excluding trading and available for sale equity securities and the available for sale warrant, at March 31, 2014 are shown by contractual maturity below (in thousands).

	Available for Sale		**Held to Maturity**	
	Amortized Cost	**Fair Value**	**Amortized Cost**	**Fair Value**
Due in one year or less	$ 135,582	$ 135,741	$	$
Due after one year through five years	117,222	126,696		
Due after five years through ten years	85,407	86,616		
Due after ten years	724,434	683,063	1,399	1,390
	1,062,645	1,032,116	1,399	1,390
Residential mortgage-backed securities	57,781	58,545	29,582	29,512
Collateralized mortgage obligations	117,336	113,832		
Commercial mortgage-backed securities	618	687		
	$ 1,238,380	$ 1,205,180	$ 30,981	$ 30,902

The Company realized a net gain from its trading securities portfolio of $0.6 million during the three months ended March 31, 2014 and a net loss of $1.2 million during the three months ended March 31, 2013, which are recorded as a component of other noninterest income within the consolidated statements of operations.

Securities with a carrying amount of $1.1 billion and $1.0 billion (with a fair value of $1.0 billion and $938.1 million) at March 31, 2014 and December 31, 2013, respectively, were pledged to secure public and trust deposits, federal funds purchased and securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

Mortgage-backed securities and collateralized mortgage obligations consist principally of Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) pass-through and participation certificates. GNMA securities are guaranteed by the full faith and credit of the United States, while FNMA and FHLMC securities are fully guaranteed by those respective United States government-sponsored agencies, and conditionally guaranteed by the full faith and credit of the United States.

At March 31, 2014 and December 31, 2013, NLC had investments on deposit in custody for various state insurance departments with carrying values of $8.6 million and $9.4 million, respectively.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

5. Non-Covered Loans and Allowance for Non-Covered Loan Losses

Non-covered loans refer to loans not covered by the FDIC loss-share agreements. Covered loans are discussed in Note 6 to the consolidated financial statements. Non-covered loans summarized by portfolio segment are as follows (in thousands).

	March 31, 2014	December 31, 2013
Commercial and industrial	$ 1,670,087	$ 1,637,266
Real estate	1,535,361	1,457,253
Construction and land development	387,382	364,551
Consumer	54,116	55,576
	3,646,946	3,514,646
Allowance for non-covered loan losses	(34,645)	(33,241)
Total non-covered loans, net of allowance	$ 3,612,301	$ 3,481,405

The Bank has lending policies in place with the goal of establishing an asset portfolio that will provide a return on stockholders equity sufficient to maintain capital to assets ratios that meet or exceed established regulations. Loans are underwritten with careful consideration of the borrower s financial condition, the specific purpose of the loan, the primary sources of repayment and any collateral pledged to secure the loan.

Underwriting procedures address financial components based on the size or complexity of the credit. The financial components include, but are not limited to, current and projected cash flows, shock analysis and/or stress testing, and trends in appropriate balance sheet and statement of operations ratios. Collateral analysis includes a complete description of the collateral, as well as determining values, monitoring requirements, loan to value ratios, concentration risk, appraisal requirements and other information relevant to the collateral being pledged. Guarantor analysis includes liquidity and cash flow analysis based on the significance the guarantors are expected to serve as secondary repayment sources. The Bank s underwriting standards are governed by adherence to its loan policy. The loan policy provides for specific guidelines by portfolio segment, including commercial and industrial, real estate, construction and land development, and consumer loans. Within each individual portfolio segment, permissible and impermissible loan types are explicitly outlined. Within the loan types, minimum requirements for the underwriting factors listed above are provided.

The Bank maintains a loan review department that reviews credit risk in response to both external and internal factors that potentially impact the performance of either individual loans or the overall loan portfolio. The loan review process reviews the creditworthiness of borrowers and determines compliance with the loan policy. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel. Results of these reviews are presented to management and the Bank s board of directors.

In connection with the PlainsCapital Merger and the FNB Transaction, the Company acquired non-covered loans both with and without evidence of credit quality deterioration since origination. The following table presents the carrying values and the outstanding balances of the non-covered PCI loans (in thousands).

	March 31, 2014	December 31, 2013
Carrying amount	$ 85,396	$ 100,392
Outstanding balance	122,881	141,983

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Changes in the accretable yield for the non-covered PCI loans were as follows (in thousands).

	Three Months Ended March 31, 2014	2013
Balance, beginning of period	$ 17,601	$ 17,553
Additions		
Increases in expected cash flows	3,475	11,996
Disposals of loans	(603)	(26)
Accretion	(2,760)	(3,277)
Balance, end of period	$ 17,713	$ 26,246

Impaired loans exhibit a clear indication that the borrower s cash flow may not be sufficient to meet principal and interest payments, which is generally when a loan is 90 days past due unless the asset is both well secured and in the process of collection. Non-covered impaired loans include non-accrual loans, troubled debt restructurings (TDRs), PCI loans and partially charged-off loans.

Non-covered PCI loans are summarized by class in the following tables (in thousands). In addition to the non-covered PCI loans, there were $5.3 million and $4.1 million of additional non-covered impaired loans at March 31, 2014 and December 31, 2013, respectively.

March 31, 2014	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
Commercial and industrial:					
Secured	$ 57,302	$ 19,727	$ 12,894	$ 32,621	$ 2,716
Unsecured	11,421	1,225		1,225	
Real estate:					
Secured by commercial properties	41,051	12,053	17,439		