Hilltop Holdings Inc.
Form 10-Q
August 05, 2013
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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 June 30, 2013

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

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

The number of shares of the registrant s common stock outstanding at August 2, 2013 was 83,958,844.

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HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2013

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	June 30, 2013 (Unaudited)	December 31, 2012
Assets		
Cash and due from banks	$ 596,351	$ 722,039
Federal funds sold and securities purchased under agreements to resell	32,939	4,421
Securities:		
Trading, at fair value	32,857	90,113
Available for sale, at fair value (amortized cost of $1,103,289 and $978,502, respectively)	1,073,522	990,953
	1,106,379	1,081,066
Loans held for sale	1,412,960	1,401,507
Loans, net of unearned income	3,253,001	3,152,396
Allowance for loan losses	(26,237)	(3,409)
Loans, net	3,226,764	3,148,987
Broker-dealer and clearing organization receivables	208,011	145,564
Insurance premiums receivable	26,987	24,615
Deferred policy acquisition costs	21,680	19,812
Reinsurance receivable, net of uncollectible amounts	6,340	18,567
Premises and equipment, net	110,937	111,381
Other assets	329,302	277,398
Goodwill	251,808	253,770
Other intangible assets, net	72,345	77,738
Total assets	$ 7,402,803	$ 7,286,865
Liabilities and Stockholders Equity		
Deposits:		
Noninterest-bearing	$ 208,702	$ 323,367
Interest-bearing	4,287,767	4,377,094
Total deposits	4,496,469	4,700,461
Broker-dealer and clearing organization payables	246,681	187,990
Reserve for losses and loss adjustment expenses	42,458	34,012
Unearned insurance premiums	90,411	82,598
Short-term borrowings	1,003,804	728,250
Notes payable	139,938	141,539
Junior subordinated debentures	67,012	67,012
Other liabilities	144,230	198,453
Total liabilities	6,231,003	6,140,315
Commitments and contingencies (see Notes 9 and 10)		
Stockholders equity:		
Hilltop Holdings stockholders equity:		
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, respectively	114,068	114,068
Common stock, $0.01 par value, 100,000,000 shares authorized; 83,955,870 and 83,487,340 shares issued and outstanding, respectively	840	835

Additional paid-in capital	1,303,118	1,304,448
Accumulated other comprehensive income (loss)	(19,347)	8,094
Accumulated deficit	(227,784)	(282,949)
Total Hilltop Holdings stockholders equity	1,170,895	1,144,496
Noncontrolling interest	905	2,054
Total stockholders equity	1,171,800	1,146,550
Total liabilities and stockholders equity	$ 7,402,803	$ 7,286,865

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 June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Interest income:				
Loans, including fees	$ 65,213	$	$ 130,099	$
Securities:				
Taxable	6,480	3,366	12,392	6,742
Tax-exempt	1,189		2,536	
Federal funds sold and securities purchased under agreements to resell	35		56	
Interest-bearing deposits with banks	242		575	
Other	3,009		5,114	
Total interest income	76,168	3,366	150,772	6,742
Interest expense:				
Deposits	3,406		6,856	
Short-term borrowings	591		1,104	
Notes payable	2,308	2,131	4,630	4,270
Junior subordinated debentures	612		1,220	
Other	826		1,276	
Total interest expense	7,743	2,131	15,086	4,270
Net interest income	68,425	1,235	135,686	2,472
Provision for loan losses	11,289		24,294	
Net interest income after provision for loan losses	57,136	1,235	111,392	2,472
Noninterest income:				
Net gains from sale of loans and other mortgage production income	142,531		270,127	
Mortgage loan origination fees	22,695		41,588	
Net insurance premiums earned	38,590	36,195	76,063	71,350
Investment and securities advisory fees and commissions	25,964		47,973	
Other	9,453	1,851	16,760	3,562
Total noninterest income	239,233	38,046	452,511	74,912
Noninterest expense:				
Employees compensation and benefits	132,715	2,272	248,905	4,498
Loss and loss adjustment expenses	48,160	39,071	69,345	61,613
Policy acquisition and other underwriting expenses	11,627	10,842	22,430	21,743
Occupancy and equipment, net	20,154	248	39,566	492
Other	47,744	2,800	95,145	4,444
Total noninterest expense	260,400	55,233	475,391	92,790

Income (loss) before income taxes	35,969	(15,952)	88,512	(15,406)
Income tax expense (benefit)	13,309	(5,243)	32,479	(5,040)
Net income (loss)	22,660	(10,709)	56,033	(10,366)
Less: Net income attributable to noncontrolling interest	568		868	
Income (loss) attributable to Hilltop Holdings	22,092	(10,709)	55,165	(10,366)
Dividends on preferred stock	1,149		1,852	
Income (loss) applicable to Hilltop Holdings common stockholders	$ 20,943	$ (10,709)	$ 53,313	$ (10,366)
Earnings (loss) per common share:				
Basic	$ 0.25	$ (0.19)	$ 0.64	$ (0.18)
Diluted	$ 0.24	$ (0.19)	$ 0.61	$ (0.18)
Weighted average share information:				
Basic	83,490	56,362	83,489	56,431
Diluted	90,294	56,362	90,125	56,431

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income (loss)	$ 22,660	$ (10,709)	$ 56,033	$ (10,366)
Other comprehensive income (loss):				
Unrealized losses on securities available for sale, net of tax of $(15,249), $(1,075), $(14,776) and $(2,906)	(28,320)	(1,996)	(27,441)	(5,397)
Comprehensive income (loss)	(5,660)	(12,705)	28,592	(15,763)
Less: comprehensive income attributable to noncontrolling interest	568		868	
Comprehensive income (loss) applicable to Hilltop Holdings	$ (6,228)	$ (12,705)	$ 27,724	$ (15,763)

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands)

(Unaudited)

	Preferred Stock		Common Stock		Additional Paid-in	Accumulated Other Comprehensive	Accumulated	Total Hilltop Holdings Stockholders	Noncontrolling	Total Stockholders
	Shares	**Amount**	**Shares**	**Amount**	**Capital**	**Income (Loss)**	**Deficit**	**Equity**	**Interest**	**Equity**
Balance, December 31, 2011		$	56,501	$ 565	$ 918,192	$ 13,983	$ (277,357)	$ 655,383	$	$ 655,383
Net loss							(10,366)	(10,366)		(10,366)
Other comprehensive loss						(5,397)		(5,397)		(5,397)
Common stock issued to board members			2		24			24		24
Repurchase and retirement of common stock			(141)	(1)	(1,161)			(1,162)		(1,162)
Stock-based compensation expense					244			244		244
Balance, June 30, 2012		$	56,362	$ 564	$ 917,299	$ 8,586	$ (287,723)	$ 638,726	$	$ 638,726
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							55,165	55,165	868	56,033
Other comprehensive loss						(27,441)		(27,441)		(27,441)
Stock-based compensation expense					480			480		480
Common stock issued to board members			4		47			47		47
Issuance of restricted common stock			465	5	(5)					
Dividends on preferred stock					(1,852)			(1,852)		(1,852)
Cash distributions to noncontrolling interest									(2,017)	(2,017)
Balance, June 30, 2013	114	$ 114,068	83,956	$ 840	$ 1,303,118	$ (19,347)	$ (227,784)	$ 1,170,895	$ 905	$ 1,171,800

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended June 30, 2013	2012
Operating Activities		
Net income (loss)	$ 56,033	$ (10,366)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities		
Provision for loan losses	24,294	
Depreciation, amortization and accretion, net	(18,032)	690
Deferred income taxes	(11,528)	(5,040)
Other, net	533	321
Net change in securities purchased under resale agreements	(3,237)	
Net change in trading securities	57,256	
Net change in broker-dealer and clearing organization receivables	(76,430)	
Net change in other assets	34,972	(507)
Net change in broker-dealer and clearing organization payables	17,281	
Net change in loss and loss adjustment expense reserve	8,446	7,252
Net change in unearned insurance premiums	7,813	5,973
Net change in other liabilities	(37,247)	105
Net gains from sale of loans	(270,127)	
Loans originated for sale	(6,545,177)	
Proceeds from loans sold	6,769,795	
Net cash provided by (used in) operating activities	14,645	(1,572)
Investing Activities		
Proceeds from sales, maturities and principal reductions of securities available for sale	96,069	3,436
Purchases of securities available for sale	(223,570)	(2,717)
Net change in loans	(51,027)	
Purchases of premises and equipment and other assets	(11,417)	(93)
Proceeds from sales of premises and equipment and other real estate owned	4,859	
Net cash paid for Federal Home Loan Bank and Federal Reserve Bank stock	(21,219)	
Net cash provided by (used in) investing activities	(206,305)	626
Financing Activities		
Net change in deposits	(179,826)	
Net change in short-term borrowings	275,554	
Payments on notes payable	(1,601)	
Payments to repurchase common stock		(1,162)
Dividends paid	(703)	
Net cash distributed to noncontrolling interest	(2,017)	
Other, net	(154)	
Net cash provided by (used in) financing activities	91,253	(1,162)
Net change in cash and cash equivalents	(100,407)	(2,108)
Cash and cash equivalents, beginning of period	726,460	578,520
Cash and cash equivalents, end of period	$ 626,053	$ 576,412

Supplemental Disclosures of Cash Flow Information				
Cash paid for interest	$	14,889	$	4,180
Cash paid for income taxes, net of refunds	$	40,949	$	
Supplemental Schedule of Non-Cash Activities				
Conversion of loans to other real estate owned	$	1,718	$	

See accompanying notes.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

1. Summary of Significant Accounting and Reporting Policies

Nature of Operations

Hilltop Holdings Inc. (Hilltop or the Company) is a holding company that endeavors to make acquisitions or effect business combinations. In connection with this strategy, on November 30, 2012, Hilltop became a financial holding company registered under the Bank Holding Company Act of 1956, as amended by the Gramm-Leach-Bliley Act of 1999, and acquired PlainsCapital Corporation pursuant to an agreement and plan of merger whereby PlainsCapital Corporation merged with and into our wholly owned subsidiary (the Merger), which survived the Merger under the name PlainsCapital Corporation (PlainsCapital).

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. Certain disclosures within the notes to consolidated financial statements are specific to financial products and services of PlainsCapital and its subsidiaries and therefore include information at June 30, 2013 and December 31, 2012 and relating to the three and six months ended June 30, 2013.

Prior to the consummation of the Merger, Hilltop s primary operations were limited to providing fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the southern United States through Hilltop s wholly owned property and casualty insurance holding company, National Lloyds Corporation (NLC), formerly known as NLASCO, Inc.

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 (consisting primarily of normal recurring accruals) 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, 2012. 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 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 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, reserves for losses and loss adjustment expenses, the mortgage loan indemnification liability and the potential impairment of assets are particularly subject to change.

The presentation of Hilltop s historical consolidated financial statements has been modified and certain items in the prior period financial statements have been reclassified to conform to the current period presentation, which is more consistent with that of a financial institution that provides an array of financial products and services.

Hilltop owns 100% of the outstanding stock of PlainsCapital. PlainsCapital owns 100% of the outstanding stock of PlainsCapital Bank (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), PNB Aero Services, Inc. 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.

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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). Through a series limited liability company structure, Ventures establishes one or more separate operating divisions with select business partners, such as home builders, to originate residential mortgage loans.

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 stock 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. PlainsCapital Acquisition

After the close of business on November 30, 2012, Hilltop acquired PlainsCapital Corporation in a stock and cash transaction. PlainsCapital Corporation merged with and into Meadow Corporation, a wholly owned subsidiary of Hilltop, with Meadow Corporation continuing as the surviving entity under the name PlainsCapital Corporation . Based on Hilltop s closing stock price on November 30, 2012, the total purchase price was $813.5 million, consisting of 27.1 million shares of common stock, $311.8 million in cash and the issuance of 114,068 shares of Hilltop Non-Cumulative Perpetual Preferred Stock, Series B. The fair market value of assets acquired, excluding goodwill, totaled $6.5 billion, including $3.2 billion of loans, $730.8 million of investment securities and $70.7 million of identifiable intangibles. The fair market value of the liabilities assumed was $5.9 billion, including $4.5 billion of deposits.

The Merger 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 acquisition date fair values. The Company initially recorded $230.1 million of goodwill in connection with the Merger, representing the inherent long-term value expected from the business opportunities created from combining PlainsCapital with Hilltop. The amount of goodwill recorded in connection with the Company s acquisition of PlainsCapital Corporation is not deductible for tax purposes. The Company used significant estimates and assumptions to value the identifiable assets acquired and liabilities assumed. The purchase date valuations are considered preliminary and are subject to change for up to one year after the acquisition date. During the three months ended March 31, 2013, the Company reduced goodwill related to the PlainsCapital acquisition by $2.0 million for a purchase accounting adjustment related to the valuation of a capital lease obligation. The Company made no adjustments to its purchase price allocation during the three months ended June 30, 2013.

The operations acquired in the Merger have been included in Hilltop s financial results since December 1, 2012. The following table presents pro forma results for the three and six months ended June 30, 2012 had the acquisition taken place on January 1, 2011 (in thousands). The pro forma financial information combines the historical results of Hilltop and PlainsCapital Corporation and includes the estimated impact of purchase accounting adjustments. The purchase accounting adjustments reflect the impact of recording the acquired loans at fair value, including the estimated accretion of the purchase discount on the loan portfolio and related adjustments to PlainsCapital s provision for loan losses. Accretion estimates were based on the acquisition date purchase discount on the loan portfolio, as it was not practicable to determine the amount of discount that would have been recorded based on economic conditions that existed on January 1,

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

2011. The pro forma results do not include any potential operating cost savings as a result of the Merger. Further, certain costs associated with any restructuring or integration activities are also not reflected in the pro forma results. Pro forma results include the acquisition-related merger and restructuring charges incurred during the period. The pro forma results are not indicative of what would have occurred had the acquisition taken place on the indicated date.

	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
Net interest income	$ 54,205	$ 107,768
Other revenues	206,465	393,437
Net income	16,042	38,729

3. Fair Value Measurements

Fair Value Measurements and Disclosures

Hilltop 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.

- *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

Hilltop has elected to measure substantially all of PrimeLending s mortgage loans held for sale at fair value under the provisions of the Fair Value Option Subsections of the ASC (Fair Value Option). Hilltop 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. Hilltop 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

At June 30, 2013, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option and the unpaid principal balance of those loans was $1.41 billion. At December 31, 2012, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option was $1.40 billion, while the unpaid principal balance of those loans was $1.36 billion. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

Hilltop holds a number of financial instruments that are measured at fair value on a recurring basis, either by the application of 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).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
June 30, 2013				
Cash and cash equivalents	$ 629,290	$	$	$ 629,290
Trading securities		32,857		32,857
Available for sale securities	20,798	997,214	55,510	1,073,522
Loans held for sale		1,412,293		1,412,293
Derivative assets		51,348		51,348
Mortgage servicing asset			7,111	7,111
Trading liabilities		47		47
Derivative liabilities		2,686		2,686

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2012				
Cash and cash equivalents	$ 726,460	$	$	$ 726,460
Trading securities		90,113		90,113
Available for sale securities	20,428	914,248	56,277	990,953
Loans held for sale		1,400,737		1,400,737
Derivative assets		15,697		15,697
Mortgage servicing asset			2,080	2,080
Time deposits		1,073		1,073
Trading liabilities		3,164		3,164
Derivative liabilities		1,080		1,080

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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	Issuances	Total Gains or Losses (Realized or Unrealized) Included in Net Income (Loss)	Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended June 30, 2013						
Available for sale securities	$ 58,801	$	$	$	$ (3,291)	$ 55,510
Mortgage servicing asset	4,430		2,180	501		7,111
Total	$ 63,231	$	$ 2,180	$ 501	$ (3,291)	$ 62,621
Six months ended June 30, 2013						
Available for sale securities	$ 56,277	$	$	$	$ (767)	$ 55,510
Mortgage servicing asset	2,080		4,305	726		7,111
Total	$ 58,357	$	$ 4,305	$ 726	$ (767)	$ 62,621
Three months ended June 30, 2012						
Available for sale securities	$ 56,560	$	$	$	$ (1,983)	$ 54,577
Total	$ 56,560	$	$	$	$ (1,983)	$ 54,577
Six months ended June 30, 2012						
Available for sale securities	$ 60,377	$	$	$	$ (5,800)	$ 54,577
Total	$ 60,377	$	$	$	$ (5,800)	$ 54,577

All net unrealized gains (losses) in the table above are reflected in the accompanying consolidated financial statements. The unrealized gains (losses) relate to financial instruments still held at June 30, 2013. The available for sale securities noted in the tables above reflect Hilltop s note receivable and warrant with SWS Group, Inc. (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.

The mortgage servicing asset is valued by projecting net servicing cash flows, which are then discounted to estimate the fair value. The fair value of the mortgage servicing 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.

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

The following tables present 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 June 30, 2013			Three Months Ended June 30, 2012		
	Net Gains from Sale of Loans	Other Noninterest Income	Total Changes in Fair Value	Net Gains from Sale of Loans	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	$ (36,203)	$	$ (36,203)	$	$	$
Mortgage servicing asset	2,681		2,681			
Time deposits		4	4			

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

	Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option					
	Six Months Ended June 30, 2013			Six Months Ended June 30, 2012		
	Net Gains from Sale of Loans	Other Noninterest Income	Total Changes in Fair Value	Net Gains from Sale of Loans	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	$ (41,641)	$	$ (41,641)	$	$	$
Mortgage servicing asset	5,031		5,031			
Time deposits		12	12			

Hilltop also determines the fair value of certain assets and liabilities on a non-recurring basis. 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 Hilltop reports impaired loans based on underlying fair value of the collateral through specific allowances within the allowance for loan losses. Hilltop acquired impaired, or purchased credit impaired (PCI) loans with a fair value of $172.9 million upon completion of the Merger. 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. At June 30, 2013, PCI loans with a carrying amount of $138.3 million had been reduced by specific allowances within the allowance for loan losses of $0.7 million, resulting in a reported fair value of $137.6 million.

Other Real Estate Owned Hilltop reports other real estate owned 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 other real estate owned. Subsequent to the initial transfer to other real estate owned, downward valuation adjustments are charged against earnings. Hilltop primarily determines fair value using Level 2 inputs consisting of independent appraisals. At June 30, 2013, the estimated fair value of other real estate owned was $8.1 million.

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 filed with the SEC on March 15, 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).

	Carrying Amount	Estimated Fair Value Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
June 30, 2013					
Financial assets:					
Loans, net	$ 3,226,764	$	$	$ 3,253,776	$ 3,253,776
Broker-dealer and clearing organization receivables	208,011		208,011		208,011
Other assets	58,145		58,145		58,145
Financial liabilities:					
Deposits	4,496,469		4,499,430		4,499,430
Broker-dealer and clearing organization payables	246,681		246,681		246,681
Short-term borrowings	1,003,804		1,003,804		1,003,804
Debt	206,950		222,627		222,627
Other liabilities	4,497		4,497		4,497

	Carrying Amount	Estimated Fair Value Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
December 31, 2012					
Financial assets:					
Loans, net	$ 3,148,987	$	$	$ 3,148,987	$ 3,148,987
Broker-dealer and clearing organization receivables	145,564		145,564		145,564
Other assets	59,094		59,094		59,094
Financial liabilities:					
Deposits	4,700,461		4,698,848		4,698,848
Broker-dealer and clearing organization payables	187,990		187,990		187,990
Short-term borrowings	728,250		728,250		728,250
Debt	208,551		217,092		217,092
Other liabilities	4,400		4,400		4,400

4. Securities

The amortized cost and fair value of available for sale securities are summarized as follows (in thousands).

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2013				
U.S. Treasury securities	$ 8,751	$ 96	$ (33)	$ 8,814
U.S. government agencies:				
Bonds	625,906	573	(30,716)	595,763
Residential mortgage-backed securities	16,192	348	(453)	16,087
Collateralized mortgage obligations	146,165	322	(1,607)	144,880
Corporate debt securities	71,176	5,045	(262)	75,959
States and political subdivisions	161,026	282	(6,540)	154,768
Commercial mortgage-backed securities	879	64		943
Equity securities	19,575	1,223		20,798
Note receivable	41,551	1,860		43,411
Warrant	12,068	31		12,099
Totals	$ 1,103,289	$ 9,844	$ (39,611)	$ 1,073,522

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2012				
U.S. Treasury securities	$ 7,046	$ 141	$ (2)	$ 7,185
U.S. government agencies:				
Bonds	524,888	1,663	(314)	526,237
Residential mortgage-backed securities	18,473	490	(70)	18,893
Collateralized mortgage obligations	97,812	191	(79)	97,924
Corporate debt securities	79,716	7,461		87,177
States and political subdivisions	177,701	196	(2,138)	175,759
Commercial mortgage-backed securities	1,001	72		1,073
Equity securities	19,289	1,139		20,428
Note receivable	40,508	3,652		44,160
Warrant	12,068	49		12,117
Totals	$ 978,502	$ 15,054	$ (2,603)	$ 990,953

Available for sale equity securities includes 1,475,387 shares of SWS common stock, a note made by SWS in the aggregate principal amount of $50.0 million 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.

Information regarding available for sale securities that were in an unrealized loss position is shown in the following table (dollars in thousands).

	June 30, 2013			December 31, 2012		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
U.S. treasury securities:						
Unrealized loss for less than twelve months	4	$ 6,345	$ 33	2	$ 2,427	$ 2
Unrealized loss for twelve months or longer						
	4	6,345	33	2	2,427	2
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	38	567,672	30,716	14	236,305	314
Unrealized loss for twelve months or longer						
	38	567,672	30,716	14	236,305	314

Residential mortgage-backed securities:									
Unrealized loss for less than twelve months	6		11,345		453	7		12,279		70
Unrealized loss for twelve months or longer										
	6		11,345		453	7		12,279		70
Collateralized mortgage obligations:										
Unrealized loss for less than twelve months	13		102,242		1,607	8		38,887		79
Unrealized loss for twelve months or longer										
	13		102,242		1,607	8		38,887		79
Corporate debt securities:										
Unrealized loss for less than twelve months	5		5,955		262					
Unrealized loss for twelve months or longer										
	5		5,955		262					
States and political subdivisions:										
Unrealized loss for less than twelve months	194		129,529		6,540	225		156,664		2,138
Unrealized loss for twelve months or longer										
	194		129,529		6,540	225		156,664		2,138
Total available for sale:										
Unrealized loss for less than twelve months	260		823,088		39,611	256		446,562		2,603
Unrealized loss for twelve months or longer										
	260	$	823,088	$	39,611	256	$	446,562	$	2,603

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

During the three and six months ended June 30, 2013 and 2012, the Company did not record any other-than-temporary impairments. While all of the investments are monitored for potential other-than-temporary impairment, our 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 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 June 30, 2013.

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 June 30, 2013 are shown by contractual maturity below (in thousands).

	Amortized Cost	Fair Value
Due in one year or less	$ 32,528	$ 32,809
Due after one year through five years	112,253	118,200
Due after five years through ten years	45,990	46,621
Due after ten years	717,639	681,085
	908,410	878,715
Residential mortgage-backed securities	16,192	16,087
Collateralized mortgage obligations	146,165	144,880
Commercial mortgage-backed securities	879	943
	$ 1,071,646	$ 1,040,625

The Company realized a net loss from its trading securities portfolio of $1.5 million and $2.7 million during the three and six months ended June 30, 2013, respectively, which are recorded as a component of other noninterest income within the consolidated statements of operations.

Securities with a carrying amount of $781.8 million and $635.2 million (with a fair value of $748.4 million and $633.4 million) at June 30, 2013 and December 31, 2012, 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.

At both June 30, 2013 and December 31, 2012, NLC had investments on deposit in custody for various state insurance departments with carrying values of $9.3 million.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

5. Loans and Allowance for Loan Losses

Loans summarized by category are as follows (in thousands).

	June 30, 2013	December 31, 2012
Commercial and industrial	$ 1,680,713	$ 1,660,293
Real estate	1,234,025	1,184,914
Construction and land development	311,333	280,483
Consumer	26,930	26,706
	3,253,001	3,152,396
Allowance for loan losses	(26,237)	(3,409)
Total loans, net of allowance	$ 3,226,764	$ 3,148,987

PlainsCapital 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 global 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 global cash flow analysis based on the significance the guarantors are expected to serve as secondary repayment sources. PlainsCapital 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.

PlainsCapital 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 Merger, Hilltop acquired loans both with and without evidence of credit quality deterioration since origination. The acquired loans were initially recorded at fair value as of the date of the Merger with no carryover of any allowance for loan losses. The following table presents the outstanding contractual balances and the carrying values of the PCI loans (in thousands).

	June 30, 2013	December 31, 2012
Carrying amount	$ 138,308	$ 166,780
Outstanding balance	187,206	222,674

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Balance, beginning of period	$ 26,246	$ 17,553
Increases in expected cash flows	141	12,137
Disposals of loans	(1,806)	(1,832)
Accretion	(4,463)	(7,740)
Balance, end of period	$ 20,118	$ 20,118

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. Impaired loans include non-accrual loans, troubled debt restructurings (TDRs), PCI loans and partially charged-off loans.

PCI loans are summarized by class in the following tables (in thousands). In addition to the PCI loans, there were $1.4 million of additional impaired loans at June 30, 2013.

	Unpaid Contractual Principal Balance	Nonaccretable Difference	Accretable Yield	Total Recorded Investment	Related Allowance
June 30, 2013					
Commercial and industrial:					
Secured	$ 71,408	$ 18,708	$ 3,530	$ 54,763	$ 333
Unsecured	10,542	4,936	4,832	1,975	
Real estate:					
Secured by commercial properties	58,540	13,657	7,199	48,151	215
Secured by residential properties	8,012	1,676	721	6,163	50
Construction and land development:					
Residential construction loans					
Commercial construction loans and land development	38,623	10,015	3,827	27,190	61
Consumer	81	14	9	66	
	$ 187,206	$ 49,006	$ 20,118	$ 138,308	$ 659

	Unpaid Contractual Principal Balance	Nonaccretable Difference	Accretable Yield	Total Recorded Investment
December 31, 2012				

Commercial and industrial:				
Secured	$ 91,633	$ 24,982	$ 6,114	$ 67,967
Unsecured	12,198	8,707	472	3,419
Real estate:				
Secured by commercial properties	66,736	15,816	7,294	55,519
Secured by residential properties	8,690	2,251	557	6,728
Construction and land development:				
Residential construction loans	995	493	40	708
Commercial construction loans and land development	42,330	9,113	3,067	32,362
Consumer	92	16	9	77
	$ 222,674	$ 61,378	$ 17,553	$ 166,780

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Average investment in PCI loans is summarized by class in the following table (in thousands).

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Commercial and industrial:		
Secured	$ 61,715	$ 61,365
Unsecured	2,385	2,697
Real estate:		
Secured by commercial properties	49,687	51,835
Secured by residential properties	7,131	6,446
Construction and land development:		
Residential construction loans		354
Commercial construction loans and land development	26,681	29,776
Consumer	69	72
	$ 147,668	$ 152,545

Non-accrual loans, excluding those classified as held for sale, are summarized by class in the following table (in thousands).

	June 30, 2013
Commercial and industrial:	
Secured	$ 16,743
Unsecured	
Real estate:	
Secured by commercial properties	3,085
Secured by residential properties	222
Construction and land development:	
Residential construction loans	
Commercial construction loans and land development	1,612
Consumer	
	$ 21,662

At June 30, 2013, non-accrual loans included PCI loans of $20.3 million for which discount accretion has been suspended because the extent and timing of cash flows from these PCI loans can no longer be reasonably estimated. All PCI loans at December 31, 2012 were considered to be performing due to the application of the accretion method. In addition to the non-accrual loans in the table above, $1.9 million and $1.8 million of real estate loans secured by residential properties and classified as held for sale were in non-accrual status at June 30, 2013 and December 31, 2012, respectively.

Interest income recorded on non-accrual loans for the three and six months ended June 30, 2013 was nominal.

PlainsCapital classifies loan modifications as TDRs when it concludes that it has both granted a concession to a debtor and that the debtor is experiencing financial difficulties. Loan modifications are typically structured to create affordable payments for the debtor and can be achieved in a variety of ways. PlainsCapital modifies loans by reducing interest rates and/or lengthening loan amortization schedules. PlainsCapital also reconfigures a single loan into two or more loans (A/B Note). The typical A/B Note restructure results in a bad loan which is charged off and a good loan or loans

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(Unaudited)

the terms of which comply with the Bank s customary underwriting policies. The debt charged off on the bad loan is not forgiven to the debtor.

Information regarding TDRs granted is shown in the following tables (in thousands). All TDRs granted relate to PCI loans. At June 30, 2013, PlainsCapital had $0.4 million in unadvanced commitments to borrowers whose loans have been restructured in TDRs.

	Recorded Investment in Loans Modifed by			
	A/B Note	Interest Rate Adjustment	Payment Term Extension	Total Modification
Three months ended June 30, 2013				
Commercial and industrial:				
Secured	$	$	$ 9,853	$ 9,853
Unsecured				
Real estate:				
Secured by commercial properties				
Secured by residential properties				
Construction and land development:				
Residential construction loans				
Commercial construction loans and land development				
Consumer				
	$	$	$ 9,853	$ 9,853

	Recorded Investment in Loans Modifed by			
	A/B Note	Interest Rate Adjustment	Payment Term Extension	Total Modification
Six months ended June 30, 2013				
Commercial and industrial:				
Secured	$	$	$ 9,858	$ 9,858
Unsecured				
Real estate:				
Secured by commercial properties			272	272
Secured by residential properties			1,047	1,047
Construction and land development:				
Residential construction loans				
Commercial construction loans and land development			603	603
Consumer				
	$	$	$ 11,780	$ 11,780

An analysis of the aging of PlainsCapital s loan portfolio is shown in the following tables (in thousands).

	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans Past Due 90 Days or More
June 30, 2013								
Commercial and industrial:								
Secured	$ 3,053	$ 613	$ 85	$ 3,751	$ 1,514,462	$ 54,763	$ 1,572,976	$ 27
Unsecured	60	3		63	105,699	1,975	107,737	
Real estate:								
Secured by commercial properties	439	287		726	924,379	48,151	973,256	
Secured by residential properties	533	106	59	698	253,908	6,163	260,769	
Construction and land development:								
Residential construction loans					48,061		48,061	
Commercial construction loans and land development	213	59		272	235,810	27,190	263,272	
Consumer	74			74	26,790	66	26,930	
	$ 4,372	$ 1,068	$ 144	$ 5,584	$ 3,109,109	$ 138,308	$ 3,253,001	$ 27

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans Past Due 90 Days or More
December 31, 2012								
Commercial and industrial:								
Secured	$ 7,844	$ 348	$ 2,131	$ 10,323	$ 1,473,242	$ 67,967	$ 1,551,532	$ 2,000
Unsecured	3			3	105,339	3,419	108,761	
Real estate:								
Secured by commercial properties	714			714	868,070	55,519	924,303	
Secured by residential properties	755	101		856	253,027	6,728	260,611	
Construction and land development:								
Residential construction loans					47,461	708	48,169	
Commercial construction loans and land development	63			63	199,889	32,362	232,314	
Consumer	84			84	26,545	77	26,706	
	$ 9,463	$ 449	$ 2,131	$ 12,043	$ 2,973,573	$ 166,780	$ 3,152,396	$ 2,000

Management tracks credit quality trends on a quarterly basis related to: (i) past due levels, (ii) non-performing asset levels, (iii) classified loan levels, (iv) net charge-offs, and (v) general economic conditions in the state and local markets.

PlainsCapital utilizes a risk grading matrix to assign a risk grade to each of the loans in its portfolio. A risk rating is assigned based on an assessment of the borrower s management, collateral position, financial capacity, and economic factors. The general characteristics of the various risk grades are described below.

Pass Pass loans present a range of acceptable risks to the Bank. Loans that would be considered virtually risk-free are rated Pass low risk. Loans that exhibit sound standards based on the grading factors above and present a reasonable risk to the Bank are rated Pass normal risk. Loans that exhibit a minor weakness in one or more of the grading criteria but still present an acceptable risk to the Bank are rated Pass high risk.

Special Mention Special Mention loans have potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may result in a deterioration of the repayment prospects for the loans and weaken the Bank s credit position at some future date. Special Mention loans are not adversely classified and do not expose the Bank to sufficient risk to require adverse classification.

Substandard Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Many substandard loans are considered impaired.

PCI PCI loans exhibited evidence of credit deterioration at acquisition that made it probable that all contractually required principal payments would not be collected.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables present the internal risk grades of loans, as previously described, in the portfolio by class (in thousands).

	Pass	Special Mention	Substandard	PCI	Total
June 30, 2013					
Commercial and industrial:					
Secured	$ 1,499,934	$ 360	$ 17,919	$ 54,763	$ 1,572,976
Unsecured	105,514	95	153	1,975	107,737
Real estate:					
Secured by commercial properties	924,781		324	48,151	973,256
Secured by residential properties	250,691		3,915	6,163	260,769
Construction and land development:					
Residential construction loans	48,061				48,061
Commercial construction loans and land development	235,570		512	27,190	263,272
Consumer	26,864			66	26,930
	$ 3,091,415	$ 455	$ 22,823	$ 138,308	$ 3,253,001

	Pass	Special Mention	Substandard	PCI	Total
December 31, 2012					
Commercial and industrial:					
Secured	$ 1,476,420	$ 2,515	$ 4,630	$ 67,967	$ 1,551,532
Unsecured	105,142	200		3,419	108,761
Real estate:					
Secured by commercial properties	868,784			55,519	924,303
Secured by residential properties	253,883			6,728	260,611
Construction and land development:					
Residential construction loans	47,461			708	48,169
Commercial construction loans and land development	199,952			32,362	232,314
Consumer	26,629			77	26,706
	$ 2,978,271	$ 2,715	$ 4,630	$ 166,780	$ 3,152,396

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management s best estimate of probable losses inherent in the existing portfolio of loans. Management has responsibility for determining the level of the allowance for loan losses, subject to review by the Audit Committee of our Board of Directors and the Loan Review Committee of the Bank s Board of Directors.

It is management s responsibility at the end of each quarter, or more frequently as deemed necessary, to analyze the level of the allowance for loan losses to ensure that it is appropriate for the estimated credit losses in the portfolio consistent with the Interagency Policy Statement on the Allowance for Loan and Lease Losses and the Receivables and Contingencies Topics of the ASC. Estimated credit losses are the probable current amount of loans that the Company will be unable to collect given facts and circumstances as of the evaluation date. When management determines that a loan or portion thereof is uncollectible, the loan, or portion thereof, is charged off against the allowance for loan losses. Any subsequent recovery of charged-off loans is added back to the allowance for loan losses. As a result of the Merger on November 30, 2012, PlainsCapital s loan portfolio is now designated into two populations: acquired loans and originated loans. The allowance for loan losses is calculated separately for the acquired and originated loans.

Originated Loans

The Company has developed a methodology that seeks to determine an allowance within the scope of the Receivables and Contingencies Topics of the ASC. Each of the loans that has been determined to be impaired is within the scope of the Receivables Topic and is individually evaluated for impairment using one of three impairment measurement methods as of the evaluation date: (1) the present value of expected future discounted cash flows on the loan, (2) the loan s observable market price, or (3) the fair value of the collateral if the loan is collateral dependent. Specific reserves are provided in the estimate of the allowance based on the measurement of impairment under these three methods, except for collateral dependent loans, which require the fair value method. All non-impaired loans are within the scope of the Contingencies Topic. Estimates of loss for the Contingencies Topic are calculated based on historical loss experience by loan portfolio segment adjusted for changes in trends, conditions, and other relevant factors that affect repayment of loans

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as of the evaluation date. While historical loss experience provides a reasonable starting point for the analysis, historical losses, or recent trends in losses, are not the sole basis upon which to determine the appropriate level for the allowance for loan losses. Management considers recent qualitative or environmental factors that are likely to cause estimated credit losses associated with the existing portfolio to differ from historical loss experience, including but not limited to: changes in lending policies and procedures; changes in underwriting standards; changes in economic and business conditions and developments that affect the collectability of the portfolio; the condition of various market segments; changes in the nature and volume of the portfolio and in the terms of loans; changes in lending management and staff; changes in the volume and severity of past due loans, the volume of non-accrual loans, and the volume and severity of adversely classified or graded loans; changes in the loan review system; changes in the value of underlying collateral for collateral-dependent loans; and any concentrations of credit and changes in the level of such concentrations.

The loan review program is designed to identify and monitor problem loans by maintaining a credit grading process, requiring that timely and appropriate changes be made to reviewed loans and coordinating the delivery of the information necessary to assess the appropriateness of the allowance for loan losses. Loans are evaluated for impairment when: (i) payments on the loan are delayed, typically by 90 days or more (unless the loan is both well secured and in the process of collection), (ii) the loan becomes classified, (iii) the loan is being reviewed in the normal course of the loan review scope, or (iv) the loan is identified by the servicing officer as a problem.

Homogeneous loans, such as consumer installment loans, residential mortgage loans and home equity loans, are not individually reviewed and are generally risk graded at the same levels. The risk grade and reserves are established for each homogeneous pool of loans based on the expected net charge-offs from current trends in delinquencies, losses or historical experience and general economic conditions. At June 30, 2013 and December 31, 2012, there were no material delinquencies in these types of loans.

Acquired Loans

Purchased loans acquired in a business combination are recorded at their estimated fair value on their purchase date and with no carryover of the related allowance for loan losses. Performing acquired loans are subsequently evaluated for any required allowance at each reporting date. An allowance for loan losses is calculated using a methodology similar to that described above for originated loans. The allowance as determined for each loan is compared to the remaining fair value discount for that loan. If greater, the excess is recognized as an addition to the allowance through a provision for loan losses. If less than the discount, no additional allowance is recorded. Charge-offs and losses first reduce any remaining fair value discount for the loan and once the discount is depleted, losses are applied against the allowance established for that loan.

For PCI loans, cash flows expected to be collected are recast quarterly for each loan. These evaluations require the continued use and updating of key assumptions and estimates such as default rates, loss severity given default and prepayment speed assumptions, similar to those used for the initial fair value estimate. Management judgment must be applied in developing these assumptions. If expected cash flows for a loan decreases, an increase in the allowance for loan losses is made through a charge to the provision for loan losses. If expected cash flows for a loan increase, any previously established allowance for loan losses is reversed and any remaining difference increases the accretable yield which will be taken into income over the remaining life of the loan.

The allowance is subject to regulatory examinations and determinations as to appropriateness, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Changes in the allowance for loan losses, distributed by portfolio segment, are shown below (in thousands).

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Three months ended June 30, 2013					
Balance, beginning of period	$ 8,812	$ 3,522	$ 4,286	$ 17	$ 16,637
Provision charged to operations	6,729	1,820	2,720	20	11,289
Loans charged off	(3,656)	(65)		(15)	(3,736)
Recoveries on charged off loans	1,921	62	44	20	2,047
Balance, end of period	$ 13,806	$ 5,339	$ 7,050	$ 42	$ 26,237

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Six months ended June 30, 2013					
Balance, beginning of period	$ 1,845	$ 977	$ 582	$ 5	$ 3,409
Provision charged to operations	13,640	4,257	6,317	80	24,294
Loans charged off	(4,094)	(96)		(71)	(4,261)
Recoveries on charged off loans	2,415	201	151	28	2,795
Balance, end of period	$ 13,806	$ 5,339	$ 7,050	$ 42	$ 26,237

The loan portfolio was distributed by portfolio segment and impairment methodology as shown below (in thousands).

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
June 30, 2013					
Loans individually evaluated for impairment	$ 1,144	$ 222	$	$	$ 1,366
Loans collectively evaluated for impairment	1,622,831	1,179,489	284,143	26,864	3,113,327
PCI Loans individually evaluated for impairment	56,738	54,314	27,190	66	138,308
	$ 1,680,713	$ 1,234,025	$ 311,333	$ 26,930	$ 3,253,001

[redacted]

December 31, 2012										
Loans individually evaluated for impairment	$		$		$		$		$	
Loans collectively evaluated for impairment		1,588,907		1,122,667		247,413		26,629		2,985,616
PCI Loans individually evaluated for impairment		71,386		62,247		33,070		77		166,780
	$	1,660,293	$	1,184,914	$	280,483	$	26,706	$	3,152,396

[redacted]

June 30, 2013										
Loans individually evaluated for impairment	$		$		$		$		$	
Loans collectively evaluated for impairment		13,473		5,074		6,989		42		25,578
PCI Loans individually evaluated for impairment		333		265		61				659
	$	13,806	$	5,339	$	7,050	$	42	$	26,237

	Commercial and Industrial		Real Estate		Construction and Land Development		Consumer		Total	
December 31, 2012										
Loans individually evaluated for impairment	$		$		$		$		$	
Loans collectively evaluated for impairment		1,845		977		582		5		3,409
PCI Loans individually evaluated for impairment										
	$	1,845	$	977	$	582	$	5	$	3,409

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

6. Deposits

Deposits are summarized as follows (in thousands).

	June 30, 2013	December 31, 2012
Noninterest-bearing demand	$ 208,702	$ 323,367
Interest-bearing:		
NOW accounts	138,817	106,562
Money market	2,316,332	2,357,109
Brokered - money market	263,694	263,193
Demand	39,273	75,308
Savings	174,120	180,367
Time	1,132,014	1,175,432
Brokered - time	223,517	219,123
	$ 4,496,469	$ 4,700,461

7. Short-term Borrowings

Short-term borrowings are summarized as follows (in thousands).

	June 30, 2013	December 31, 2012
Federal funds purchased	$ 105,550	$ 269,625
Securities sold under agreements to repurchase	121,354	85,725
Federal Home Loan Bank (FHLB) notes	675,000	250,000
Short-term bank loans	101,900	122,900
	$ 1,003,804	$ 728,250

Federal funds purchased and securities sold under agreements to repurchase generally mature daily, on demand, or on some other short-term basis. The Bank and FSC execute transactions to sell securities under agreements to repurchase with both customers and broker-dealers. Securities involved in these transactions are held by the Bank, FSC or the dealer.

Information concerning federal funds purchased and securities sold under agreements to repurchase is shown in the following tables (dollars in thousands).

	Six Months Ended June 30, 2013
Average balance during the period	$ 304,418
Average interest rate during the period	0.20%

	June 30, 2013	December 31, 2012
Average interest rate at end of period	0.15%	0.22%
Securities underlying the agreements at end of period		
Carrying value	$ 146,928	$ 122,153
Estimated fair value	$ 142,833	$ 122,435

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Federal Home Loan Bank (FHLB) notes mature over terms not exceeding 365 days and are collateralized by FHLB Dallas stock, nonspecified real estate loans and certain specific commercial real estate loans. Other information regarding FHLB notes is shown in the following tables (dollars in thousands).

	Six Months Ended June 30, 2013
Average balance during the period	$ 147,241
Average interest rate during the period	0.12%

	June 30, 2013	December 31, 2012
Average interest rate at end of period	0.15%	0.07%

FSC uses short-term bank loans periodically to finance securities owned, customers margin accounts and underwriting activities. Interest on the borrowings varies with the federal funds rate. The weighted average interest rate on the borrowings at June 30, 2013 and December 31, 2012 was 1.10% and 1.16%, respectively.

8. Income Taxes

Hilltop applies an estimated annual effective rate to interim period pre-tax income to calculate the income tax provision for the quarter in accordance with the principal method prescribed by the accounting guidance established for computing income taxes in interim periods. The Company s effective rate was 37.0% and 36.7% for the three and six months ended June 30, 2013, respectively. During the three and six months ended June 30, 2012, the Company recorded income tax benefits due to the loss from operations which reflected effective rates of 32.9% and 32.7%, respectively.

GAAP requires the measurement of uncertain tax positions. Uncertain tax positions are the difference between a tax position taken, or expected to be taken in a tax return, and the benefit recognized for accounting purposes. There were no uncertain tax positions at June 30, 2013 and 2012. The Company does not anticipate any significant liabilities for uncertain tax positions to arise in the next twelve months.

Hilltop files income tax returns in U.S. federal and several U.S. state jurisdictions. Hilltop is subject to tax audits in numerous jurisdictions in the U.S. until the applicable statute of limitations expires. Excluding those entities acquired as a part of the Merger, Hilltop has been examined by U.S. tax authorities for U.S. federal income tax years prior to 2010, and is under no federal or state tax audits at June 30, 2013. PlainsCapital has been examined by U.S. tax authorities for U.S. federal income tax years prior to 2010, and is not under federal tax audit at June 30, 2013.

PlainsCapital s subsidiary, FSC, is currently under state income tax audit by the Florida Department of Revenue for the 2009, 2010 and 2011 tax years. FSC voluntarily agreed to extend the statute of limitations to October 2014. FSC does not expect any significant liability to arise at the conclusion of the audit. PlainsCapital is not under any other state examinations as of June 30, 2013.

For the majority of tax jurisdictions, Hilltop and PlainsCapital are no longer subject to federal, state or local income tax examinations by tax authorities for years prior to 2009.

9. Commitments and Contingencies

Legal Matters

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Hilltop and its subsidiaries are defendants in various legal matters arising in the normal course of business. Management believes that the ultimate liability, if any, arising from these matters will not materially affect our consolidated financial condition, results of operations or cash flows taken as a whole.

Other Contingencies

The mortgage origination segment may be responsible for errors or omissions relating to its representations and warranties that each loan sold meets certain requirements, including representations as to underwriting standards and the validity of certain borrower representations in connection with the loan. If determined to be at fault, the mortgage origination segment either repurchases the affected loan from the investor or reimburses the investor s losses (a make-whole payment). The mortgage origination segment has established an indemnification liability for such probable losses based upon, among other things, the level of current unresolved repurchase requests, the volume of estimated probable future repurchase requests based on historical loss patterns, our ability to cure the defects identified in the repurchase requests, and the severity of the estimated loss upon repurchase. At June 30, 2013 and December 31, 2012, the indemnification reserve totaled $20.4 million and $19.0 million, respectively. The provision for indemnification losses was $1.0 million and $1.9 million for the three and six months ended June 30, 2013, respectively. Although management considers this reserve to be appropriate, the reserve may prove to be insufficient over time to cover ultimate losses, primarily due to unanticipated adverse changes in the economy and historical loss patterns, discrete events adversely affecting specific borrowers or industries, and/or actions taken by institutions or investors. The anticipated impact of such matters will be considered in the reserving process when known.

10. Financial Instruments with Off-Balance Sheet Risk

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit that involve varying degrees of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. Such financial instruments are recorded in the consolidated financial statements when they are funded or related fees are incurred or received. The contract amounts of those instruments reflect the extent of involvement (and therefore the exposure to credit loss) the Bank has in particular classes of financial instruments.

Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and may require payment of fees. Because some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

In the aggregate, the Bank had outstanding unused commitments to extend credit of $1.1 billion at June 30, 2013 and outstanding standby letters of credit of $35.0 million at June 30, 2013.

The Bank uses the same credit policies in making commitments and standby letters of credit as it does for on-balance sheet instruments. The amount of collateral obtained, if deemed necessary, in these transactions is based on management s credit evaluation of the borrower. Collateral held varies but may include real estate, accounts receivable, marketable securities, interest-bearing deposit accounts, inventory, and property, plant and equipment.

In the normal course of business, FSC executes, settles, and finances various securities transactions that may expose FSC to off-balance sheet risk in the event that a customer or counterparty does not fulfill its contractual obligations. Examples of such transactions include the sale of securities not yet purchased by customers or for the account of FSC, clearing agreements between FSC and various clearinghouses and broker-dealers, secured financing arrangements that involve pledged securities, and when-issued underwriting and purchase commitments.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

11. Stock-Based Compensation

Pursuant to the Hilltop Holdings 2012 Equity Incentive Plan (the 2012 Plan), the Company may grant nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, dividend equivalent rights and other awards to employees of Hilltop, its subsidiaries and outside directors of Hilltop. Upon the effectiveness of the 2012 Plan in September 2012, no additional awards were permissible under the 2003 Equity Incentive Plan (the 2003 Plan). In the aggregate, 4,000,000 shares of common stock may be delivered pursuant to awards granted under the 2012 Plan.

Effective May 2, 2013, the Compensation Committee of the Board of Directors of the Company awarded certain executives and key employees a total of 465,000 restricted shares of common stock (Restricted Stock Awards) pursuant to the 2012 Plan. These Restricted Stock Awards are subject to service conditions set forth in the grant agreements with associated costs recognized on a straight-line basis over the vesting period. The grant date fair value related to these Restricted Stock Awards was $13.25 per share, resulting in expected compensation expense of $6.2 million. At June 30, 2013, unrecognized compensation expense related to these Restricted Stock Awards was $5.8 million, which will be amortized through March 2016. These Restricted Stock Awards vest on April 1, 2016 and provide for accelerated vesting under certain conditions.

During the six months ended June 30, 2013, the Company granted 3,530 shares of common stock to members of our board of directors as compensation for director services pursuant to the 2012 Plan.

At June 30, 2013, 3,531,470 shares of common stock remain available for issuance pursuant to the 2012 Plan.

Stock options granted on November 2, 2011 pursuant to the 2003 Plan to purchase an aggregate of 600,000 shares of the Company s common stock (the Stock Option Awards) at an exercise price of $7.70 per share were outstanding at June 30, 2013. These Stock Option Awards vest in five equal installments beginning on the grant date, with the remainder vesting on each grant date anniversary through 2015. At June 30, 2013, unrecognized compensation expense related to these Stock Option Awards was $0.3 million, which will be amortized on a straight-line basis through October 2015. Additionally, these Stock Option Awards expire on November 2, 2016.

Compensation expense related to the plans was $0.4 million and $0.1 million for the three months ended June 30, 2013 and 2012, respectively. For the six months ended June 30, 2013 and 2012, compensation expense related to the plans was $0.5 million and $0.3 million, respectively.

12. Regulatory Matters

Bank

The Bank and Hilltop are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct, material effect on the consolidated financial statements. The regulations require us to meet specific capital adequacy guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the companies to maintain minimum amounts and ratios (set forth in the following table) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 and total capital (as defined) to risk-weighted assets (as defined). The Tier 1 capital (to average assets) ratio at December 31, 2012 was calculated using the average assets for the month of December 2012.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

A comparison of the Bank s and Hilltop s actual capital amounts and ratios to the minimum requirements is as follows (dollars in thousands), without giving effect to the final Basel III capital rules adopted by the Federal Reserve Board on July 2, 2013.

	June 30, 2013			
	Required		Actual	
	Amount	Ratio	Amount	Ratio
Bank:				
Tier 1 capital (to average assets)	$ 250,957	4%	$ 610,896	9.74%
Tier 1 capital (to risk-weighted assets)	191,280	4%	610,896	12.77%
Total capital (to risk-weighted assets)	382,560	8%	638,200	13.35%
Hilltop:				
Tier 1 capital (to average assets)	$ 272,625	4%	$ 930,922	13.66%
Tier 1 capital (to risk-weighted assets)	202,963	4%	930,922	18.35%
Total capital (to risk-weighted assets)	405,925	8%	958,776	18.90%

	December 31, 2012			
	Required		Actual	
	Amount	Ratio	Amount	Ratio
Bank:				
Tier 1 capital (to average assets)	$ 245,495	4%	$ 542,307	8.84%
Tier 1 capital (to risk-weighted assets)	183,308	4%	542,307	11.83%
Total capital (to risk-weighted assets)	366,615	8%	546,598	11.93%
Hilltop:				
Tier 1 capital (to average assets)	$ 266,514	4%	$ 871,379	13.08%
Tier 1 capital (to risk-weighted assets)	196,670	4%	871,379	17.72%
Total capital (to risk-weighted assets)	393,340	8%	875,670	17.81%

To be considered adequately capitalized (as defined) under regulatory requirements, the Bank must maintain minimum Tier 1 capital to total average assets and Tier 1 capital to risk-weighted assets ratios of 4%, and a total capital to risk-weighted assets ratio of 8%. Based on the actual capital amounts and ratios shown in the previous tables, the Bank s ratios place it in the well capitalized (as defined) capital category under regulatory requirements.

The minimum required capital amounts and ratios for the well capitalized category are summarized as follows (dollars in thousands).

	June 30, 2013	
	Required	Actual

	Amount	Ratio	Amount	Ratio
Bank:				
Tier 1 capital (to average assets)	$ 313,696	5%	$ 610,896	9.74%
Tier 1 capital (to risk-weighted assets)	286,920	6%	610,896	12.77%
Total capital (to risk-weighted assets)	478,200	10%	638,200	13.35%

	December 31, 2012			
	Required		Actual	
	Amount	Ratio	Amount	Ratio
Bank:				
Tier 1 capital (to average assets)	$ 306,869	5%	$ 542,307	8.84%
Tier 1 capital (to risk-weighted assets)	274,961	6%	542,307	11.83%
Total capital (to risk-weighted assets)	458,269	10%	546,598	11.93%

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Management continues to evaluate the final Basel III capital rules and their impact, which would apply to reporting periods beginning after January 1, 2015.

Financial Advisory

Pursuant to the net capital requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), FSC has elected to determine its net capital requirements using the alternative method. Accordingly, FSC is required to maintain minimum net capital, as defined in Rule 15c3-1, equal to the greater of $250,000 or 2% of aggregate debit balances, as defined in Rule 15c3-3. At June 30, 2013, FSC had: net capital of $70.1 million; the minimum net capital requirement was $3.3 million; net capital maintained by FSC was 42% of aggregate debits; and net capital in excess of the minimum requirement was $66.8 million.

Under certain conditions, FSC may be required to segregate cash and securities in a special reserve account for the benefit of customers under Rule 15c3-3. Assets segregated under the provisions of the Exchange Act are not available for general corporate purposes. FSC was required to segregate $19.0 million in cash and securities at December 31, 2012, which is included in other assets within the consolidated balance sheet.

FSC was not required to segregate cash or securities in a special reserve account for the benefit of proprietary accounts of introducing broker-dealers at June 30, 2013.