Hilltop Holdings Inc.
Form 10-Q
November 12, 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 September 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**<br>**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 November 8, 2013 was 86,857,999.

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**HILLTOP HOLDINGS INC.**

**FORM 10-Q**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2013**

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**HILLTOP HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(in thousands, except share and per share data)**

| | September 30, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 976,188 | $ 722,039 |
| Federal funds sold and securities purchased under agreements to resell | 40,086 | 4,421 |
| Securities: | | |
| Trading, at fair value | 43,254 | 90,113 |
| Available for sale, at fair value (amortized cost of $1,305,903 and $978,502, respectively) | 1,279,381 | 990,953 |
| | 1,322,635 | 1,081,066 |
| | | |
| Loans held for sale | 1,046,801 | 1,401,507 |
| Non-covered loans, net of unearned income | 3,310,224 | 3,152,396 |
| Allowance for non-covered loan losses | (33,180) | (3,409) |
| Non-covered loans, net | 3,277,044 | 3,148,987 |
| | | |
| Covered loans | 1,096,590 | |
| Broker-dealer and clearing organization receivables | 132,636 | 145,564 |
| Insurance premiums receivable | 27,006 | 24,615 |
| Deferred policy acquisition costs | 21,884 | 19,812 |
| Reinsurance receivable, net of uncollectible amounts | 7,656 | 18,567 |
| Premises and equipment, net | 187,857 | 111,381 |
| FDIC indemnification asset | 190,041 | |
| Covered other real estate owned | 119,660 | |
| Other assets | 319,758 | 277,398 |
| Goodwill | 251,808 | 253,770 |
| Other intangible assets, net | 75,942 | 77,738 |
| Total assets | $ 9,093,592 | $ 7,286,865 |
| | | |
| **Liabilities and Stockholders Equity** | | |
| Deposits: | | |
| Noninterest-bearing | $ 392,404 | $ 323,367 |
| Interest-bearing | 6,543,758 | 4,377,094 |
| Total deposits | 6,936,162 | 4,700,461 |
| | | |
| Broker-dealer and clearing organization payables | 142,411 | 187,990 |
| Reserve for losses and loss adjustment expenses | 31,267 | 34,012 |
| Unearned insurance premiums | 92,064 | 82,598 |
| Short-term borrowings | 305,297 | 728,250 |
| Notes payable | 140,111 | 141,539 |
| Junior subordinated debentures | 67,012 | 67,012 |
| Other liabilities | 172,915 | 198,453 |
| Total liabilities | 7,887,239 | 6,140,315 |
| Commitments and contingencies (see Notes 11 and 12) | | |
| Stockholders equity: | | |
| Hilltop stockholders equity: | | |
| Preferred stock, $0.01 par value, 10,000,000 shares authorized; | | |
| | 114,068 | 114,068 |

| | | | | |
|---|---|---|---|---|
| Series B, liquidation value per share of $1,000; 114,068 shares issued and outstanding, respectively | | | | |
| Common stock, $0.01 par value, 100,000,000 shares authorized; 83,958,844 and 83,487,340 shares issued and outstanding, respectively | | 840 | | 835 |
| Additional paid-in capital | | 1,302,625 | | 1,304,448 |
| Accumulated other comprehensive income (loss) | | (17,238) | | 8,094 |
| Accumulated deficit | | (194,820) | | (282,949) |
| Total Hilltop stockholders equity | | 1,205,475 | | 1,144,496 |
| Noncontrolling interest | | 878 | | 2,054 |
| Total stockholders equity | | 1,206,353 | | 1,146,550 |
| Total liabilities and stockholders equity | $ | 9,093,592 | $ | 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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Interest income: | | | | |
| Loans, including fees | $ 68,121 | $ | $ 198,220 | $ |
| Securities: | | | | |
| Taxable | 7,202 | 3,387 | 19,594 | 10,129 |
| Tax-exempt | 1,052 | | 3,588 | |
| Federal funds sold and securities purchased under agreements to resell | 35 | | 91 | |
| Interest-bearing deposits with banks | 282 | | 857 | |
| Other | 2,546 | | 7,660 | |
| Total interest income | 79,238 | 3,387 | 230,010 | 10,129 |
| | | | | |
| Interest expense: | | | | |
| Deposits | 3,685 | | 10,541 | |
| Short-term borrowings | 384 | | 1,488 | |
| Notes payable | 2,294 | 2,140 | 6,924 | 6,410 |
| Junior subordinated debentures | 591 | | 1,811 | |
| Other | 832 | | 2,108 | |
| Total interest expense | 7,786 | 2,140 | 22,872 | 6,410 |
| | | | | |
| Net interest income | 71,452 | 1,247 | 207,138 | 3,719 |
| Provision for loan losses | 10,658 | | 34,952 | |
| Net interest income after provision for loan losses | 60,794 | 1,247 | 172,186 | 3,719 |
| | | | | |
| Noninterest income: | | | | |
| Net realized gains on securities | 1,142 | | 1,142 | |
| Net gains from sale of loans and other mortgage production income | 105,337 | | 375,464 | |
| Mortgage loan origination fees | 22,091 | | 63,679 | |
| Net insurance premiums earned | 39,982 | 37,688 | 116,045 | 109,038 |
| Investment and securities advisory fees and commissions | 22,310 | | 70,283 | |
| Bargain purchase gain | 3,271 | | 3,271 | |
| Other | 11,625 | 1,895 | 28,385 | 5,457 |
| Total noninterest income | 205,758 | 39,583 | 658,269 | 114,495 |
| | | | | |
| Noninterest expense: | | | | |
| Employees compensation and benefits | 119,176 | 1,906 | 368,081 | 6,404 |
| Loss and loss adjustment expenses | 24,631 | 30,136 | 93,976 | 91,749 |
| Policy acquisition and other underwriting expenses | 11,739 | 10,121 | 34,169 | 31,864 |
| Occupancy and equipment, net | 20,974 | 246 | 60,540 | 738 |
| Other | 40,097 | 4,383 | 135,242 | 8,827 |
| Total noninterest expense | 216,617 | 46,792 | 692,008 | 139,582 |

| | | | | |
|---|---|---|---|---|
| Income (loss) before income taxes | 49,935 | (5,962) | 138,447 | (21,368) |
| Income tax expense (benefit) | 16,632 | (1,914) | 49,111 | (6,954) |
| | | | | |
| Net income (loss) | 33,303 | (4,048) | 89,336 | (14,414) |
| Less: Net income attributable to noncontrolling interest | 339 | | 1,207 | |
| | | | | |
| Income (loss) attributable to Hilltop | 32,964 | (4,048) | 88,129 | (14,414) |
| Dividends on preferred stock | 1,133 | | 2,985 | |
| Income (loss) applicable to Hilltop common stockholders | $ 31,831 | $ (4,048) | $ 85,144 | $ (14,414) |
| | | | | |
| Earnings (loss) per common share: | | | | |
| Basic | $ 0.38 | $ (0.07) | $ 1.01 | $ (0.26) |
| Diluted | $ 0.36 | $ (0.07) | $ 0.98 | $ (0.26) |
| | | | | |
| Weighted average share information: | | | | |
| Basic | 83,493 | 56,363 | 83,490 | 56,408 |
| Diluted | 90,460 | 56,363 | 90,251 | 56,408 |

*See accompanying notes.*

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**HILLTOP HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

**(in thousands)**

**(Unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Net income (loss) | $ 33,303 | $ (4,048) | $ 89,336 | $ (14,414) |
| Other comprehensive income (loss): | | | | |
| Unrealized gains (losses) on securities available for sale, net of tax of $1,135, $3,225, $(13,641) and $319, respectively | 2,109 | 5,990 | (25,332) | 593 |
| Comprehensive income (loss) | 35,412 | 1,942 | 64,004 | (13,821) |
| Less: comprehensive income attributable to noncontrolling interest | 339 | | 1,207 | |
| Comprehensive income (loss) applicable to Hilltop | $ 35,073 | $ 1,942 | $ 62,797 | $ (13,821) |

*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 Capital | Accumulated Other Comprehensive Income (Loss) | Accumulated Deficit | Total Hilltop Stockholders Equity | Noncontrolling Interest | Total Stockholders Equity |
|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | | | |
| Balance, December 31, 2011 | | $ | 56,501 | $ 565 | $ 918,192 | $ 13,983 | $ (277,357) | $ 655,383 | $ | $ 655,383 |
| Net loss | | | | | | | (14,414) | (14,414) | | (14,414) |
| Other comprehensive income | | | | | | 593 | | 593 | | 593 |
| Stock-based compensation expense | | | | | 367 | | | 367 | | 367 |
| Common stock issued to board members | | | 4 | | 38 | | | 38 | | 38 |
| Repurchase and retirement of common stock | | | (141) | (1) | (1,161) | | | (1,162) | | (1,162) |
| Balance, September 30, 2012 | | $ | 56,364 | $ 564 | $ 917,436 | $ 14,576 | $ (291,771) | $ 640,805 | $ | $ 640,805 |
| | | | | | | | | | | |
| 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 | | | | | | | 88,129 | 88,129 | 1,207 | 89,336 |
| Other comprehensive loss | | | | | | (25,332) | | (25,332) | | (25,332) |
| Stock-based compensation expense | | | | | 1,071 | | | 1,071 | | 1,071 |
| Common stock issued to board members | | | 7 | | 96 | | | 96 | | 96 |
| Issuance of restricted common stock | | | 465 | 5 | (5) | | | | | |
| Dividends on preferred stock | | | | | (2,985) | | | (2,985) | | (2,985) |
| Cash distributions to noncontrolling interest | | | | | | | | | (2,383) | (2,383) |
| Balance, September 30, 2013 | 114 | $ 114,068 | 83,959 | $ 840 | $ 1,302,625 | $ (17,238) | $ (194,820) | $ 1,205,475 | $ 878 | $ 1,206,353 |

*See accompanying notes.*

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**HILLTOP HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in thousands)**

**(Unaudited)**

| | Nine Months Ended September 30, | |
|---|---|---|
| | **2013** | **2012** |
| **Operating Activities** | | |
| Net income (loss) | $ 89,336 | $ (14,414) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities | | |
| Provision for loan losses | 34,952 | |
| Depreciation, amortization and accretion, net | (24,740) | 1,025 |
| Net realized gains on securities | (1,142) | |
| Bargain purchase gain on acquisition | (3,271) | |
| Deferred income taxes | (11,423) | (6,954) |
| Other, net | 3,914 | 495 |
| Net change in trading securities | 46,859 | |
| Net change in broker-dealer and clearing organization receivables | 2,796 | |
| Net change in other assets | 23,711 | 1,740 |
| Net change in broker-dealer and clearing organization payables | (37,386) | |
| Net change in loss and loss adjustment expense reserve | (2,745) | 1,200 |
| Net change in unearned insurance premiums | 9,466 | 6,159 |
| Net change in other liabilities | (21,993) | (2,618) |
| Net gains from sale of loans | (375,464) | |
| Loans originated for sale | (9,427,627) | |
| Proceeds from loans sold | 10,157,410 | |
| Net cash provided by (used in) operating activities | 462,653 | (13,367) |
| | | |
| **Investing Activities** | | |
| Proceeds from sales, maturities and principal reductions of securities available for sale | 211,732 | 13,225 |
| Purchases of securities available for sale | (255,142) | (2,887) |
| Net change in non-covered loans | (49,255) | |
| Purchases of premises and equipment and other assets | (20,264) | (161) |
| Proceeds from sales of premises and equipment and other real estate owned | 7,641 | |
| Net cash received for Federal Home Loan Bank and Federal Reserve Bank stock | 89 | |
| Net cash from FNB Transaction | 362,695 | |
| Net cash provided by investing activities | 257,496 | 10,177 |
| | | |
| **Financing Activities** | | |
| Net change in deposits | (1,476) | |
| Net change in short-term borrowings | (422,953) | |
| Proceeds from notes payable | 1,000 | |
| Payments on notes payable | (2,428) | |
| Payments to repurchase common stock | | (1,162) |
| Dividends paid | (1,852) | |
| Net cash distributed to noncontrolling interest | (2,383) | |
| Other, net | (243) | |
| Net cash used in financing activities | (430,335) | (1,162) |

| | | | | |
|---|---|---|---|---|
| Net change in cash and cash equivalents | | 289,814 | | (4,352) |
| Cash and cash equivalents, beginning of period | | 726,460 | | 578,520 |
| Cash and cash equivalents, end of period | $ | 1,016,274 | $ | 574,168 |
| | | | | |
| **Supplemental Disclosures of Cash Flow Information** | | | | |
| Cash paid for interest | $ | 22,513 | $ | 7,849 |
| Cash paid for income taxes, net of refunds | $ | 52,752 | $ | |
| **Supplemental Schedule of Non-Cash Activities** | | | | |
| Conversion of loans to other real estate owned | $ | 6,019 | $ | |

*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 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 an agreement and plan of merger whereby PlainsCapital Corporation merged with and into our wholly owned subsidiary (the PlainsCapital Merger ), which survived the PlainsCapital 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 September 30, 2013 and December 31, 2012 and relating to the three and nine months ended September 30, 2013.

Prior to the consummation of the PlainsCapital Merger, the Company 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 the Company s wholly owned property and casualty insurance holding company, National Lloyds Corporation ( NLC ), formerly known as NLASCO, Inc.

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 acquired branches of FNB 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. Based on preliminary purchase date valuations, the fair market value of the assets acquired was $2.2 billion, including $1.1 billion in covered loans, $286.2 million in securities, $121.0 million in covered OREO and $45.9 million in non-covered loans. The Bank also assumed $2.2 billion in liabilities, consisting primarily of deposits. FNB s expansive branch network allows the Bank to further develop its Texas footprint through expansion into the Rio Grande Valley, Houston, Corpus Christi, Laredo and El Paso markets, among others.

**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, 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, the 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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements. As discussed in Note 2 to the consolidated financial statements, the purchase date valuations for the FNB Transaction are considered preliminary because management made significant estimates and exercised significant judgment in estimating fair values and accounting due to the short time period between the Bank Closing Date and September 30, 2013.

The presentation of the Company 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 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.

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.

The following significant accounting policies are in addition to the significant accounting policies described in Note 1 to the consolidated financial statements included in our Annual Report on Form 10-K filed with the SEC on March 15, 2013.

**FDIC Indemnification Asset**

The Company has elected to account for amounts receivable under the loss-share agreements with the FDIC as an indemnification asset ( FDIC Indemnification Asset ) in accordance with FASB ASC 805. The FDIC Indemnification Asset is initially recorded at fair value, based on the discounted value of expected future cash flows under the loss-share agreements. The difference between the present value and the undiscounted cash flows the Company expects to collect from the FDIC will be accreted into noninterest income within the consolidated statements of operations over the life of the FDIC Indemnification Asset. The FDIC Indemnification Asset is reviewed quarterly and adjusted for any changes in expected cash flows based on recent performance and expectations for future performance of the covered portfolio. These adjustments are measured on the same basis as the related covered loans and covered OREO. Any increases in cash flow of the covered assets over those expected will reduce the FDIC Indemnification Asset and any decreases in cash flow of

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

the covered assets under those expected will increase the FDIC Indemnification Asset. Any amortization of changes in value is limited to the contractual term of the loss-share agreements. Increases and decreases to the FDIC Indemnification Asset are recorded as adjustments to noninterest income within the consolidated statements of operations over the life of the loss-share agreements.

**Covered Other Real Estate Owned**

Acquired OREO subject to FDIC loss-share agreements is referred to as covered OREO and reported separately in our consolidated balance sheets. Covered OREO is reported exclusive of expected reimbursement cash flows from the FDIC. Foreclosed covered loan collateral is transferred into covered OREO at the collateral s fair value, less selling costs. Covered OREO was initially recorded at its estimated fair value based on similar market comparable valuations, less estimated selling costs. Subsequently, loan collateral transferred to OREO is recorded at its net realizable value. Any subsequent valuation adjustments due to declines in fair value of the covered OREO will be charged to noninterest expense, and will be partially offset by noninterest income representing the corresponding increase to the FDIC Indemnification Asset for loss reimbursements. Any recoveries of previous valuation decreases will be credited to noninterest expense with a corresponding charge to noninterest income for the portion of the recovery that is due to the FDIC.

**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 . Pursuant to the loss-share agreements, the FDIC has agreed to reimburse the Bank the following amounts with respect to the covered assets pursuant to the loss-share agreements: (i) 80% of losses on the first $240.4 million of losses incurred; (ii) 0% of losses in excess of $240.4 million up to and including $365.7 million of losses incurred; and (iii) 80% of losses in excess of $365.7 million of losses incurred. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, from the Bank Closing Date and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date.

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 operations of FNB are included in the Company s operating results beginning September 14, 2013, but were not significant to the Company s consolidated statements of operations for the three and nine months ended September 30, 2013. Such operating results include a preliminary pre-tax bargain purchase gain of $3.3 million and are not necessarily indicative of future operating results. FNB s results of operations prior to the Bank Closing Date are not included in the Company s consolidated operating results.

Transaction-related expenses of $0.2 million associated with the FNB Transaction are included in noninterest expense within the consolidated statements of operations for the three and nine months ended September 30, 2013. Such expenses were for professional services and other incremental costs associated with the integration of FNB s operations.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 Bank Closing Date fair values. Because of the short time period between the Bank Closing Date and September 30, 2013, the Company used significant estimates and assumptions to value the identifiable assets acquired and liabilities assumed. The Bank Closing Date valuations related to loans, FDIC Indemnification Asset, covered OREO, other intangible assets, assumed liabilities and taxes are considered preliminary and could differ significantly when finalized. The amounts are also subject to adjustments based upon final settlement with the FDIC. In addition, the tax treatment of FDIC-assisted acquisitions is complex and subject to interpretations that may result in future adjustments of deferred taxes as of the Bank Closing Date. 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.

A summary of the net assets received from the FDIC and the estimated fair value adjustments resulting in the bargain purchase gain are presented below (in thousands).

| | | |
|---|---|---|
| Cost basis net assets on September 13, 2013 | $ | 182,169 |
| Cash payment received from the FDIC | | 45,000 |
| Fair value adjustments: | | |
| Securities | | (3,341) |
| Loans | | (337,572) |
| Premises and equipment | | (1,358) |
| Other real estate owned | | (69,456) |
| FDIC indemnification asset | | 189,773 |
| Other intangible assets | | 6,380 |
| Deposits | | (8,282) |
| Other | | (42) |
| Bargain purchase gain | $ | 3,271 |

In FDIC-assisted transactions, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer s bid, the FDIC may be required to make a cash payment to the acquirer or the acquirer may be required to make payment to the FDIC. In the FNB Transaction, cost basis net assets of $182.2 million and an initial cash payment received from the FDIC of $45.0 million were transferred to the Bank. This initial cash payment from the FDIC is subject to adjustment and settlement. The bargain purchase gain represents the excess of the estimated fair value of the assets acquired over the estimated fair value of the liabilities assumed.

The FDIC bid form provided a list of premises owned by FNB for sale at fixed prices. The Bank purchased 44 premises owned by FNB in connection with its bid for an aggregate premise purchase price of $59.5 million. For those premises owned by FNB that the Bank declined to purchase in its bid, the Bank had an exclusive option to purchase those premises during the 30-day period following the Bank Closing Date. In connection with that option, the Bank purchased an additional five premises owned by FNB on October 15, 2013, for an aggregate purchase price of $3.8 million. The Bank has a 90-day exclusive option to purchase owned premises not listed on the bid form. The Bank also has a 90-day option to assume the leases of premises leased by FNB. The Bank is required to purchase all data management equipment and, other certain special assets, furniture, fixtures and equipment, in each case at an appraised value at any premises purchased or leased by the Bank. The

Bank paid $9.8 million to the FDIC for furniture, fixtures and data management equipment. The Bank is required to pay rent to the FDIC on premises owned or leased by FNB and furniture and equipment at such premises until it surrenders such premises to the FDIC. These incremental assets are reflected at fair value in the table above and were recorded subsequent to September 30, 2013.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The resulting fair values of the identifiable assets acquired, and liabilities assumed, of FNB at September 13, 2013 are summarized in the following table (in thousands).

| | | |
|---|---|---|
| Cash and due from banks | $ | 362,695 |
| Securities | | 286,214 |
| Non-covered loans | | 45,915 |
| Covered loans | | 1,105,421 |
| Premises and equipment | | 71,806 |
| FDIC indemnification asset | | 189,773 |
| Covered other real estate owned | | 120,985 |
| Other assets | | 39,709 |
| Other intangible assets | | 6,380 |
| Total identifiable assets acquired | | 2,228,898 |
| | | |
| Deposits | | (2,211,740) |
| Other liabilities | | (13,887) |
| Total liabilities assumed | | (2,225,627) |
| Net identifiable assets acquired/bargain purchase gain | $ | 3,271 |

The Bank acquired loans both with and without evidence of credit quality deterioration since origination. Based on preliminary purchase date valuations, the Bank s portfolio of acquired loans had a fair market value of $1.2 billion as of the Bank Closing Date, with no carryover of any allowance for loan losses. Acquired loans were preliminarily segregated between those considered to be credit impaired, or purchased credit impaired ( PCI ) loans, and those deemed performing. The following table presents preliminary details on acquired loans at the Bank Closing Date (in thousands).

| | | **Acquired Performing** | | **PCI Loans** | | **Total Loans** |
|---|---|---|---|---|---|---|
| Commercial and industrial | $ | 44,207 | $ | 50,705 | $ | 94,912 |
| Real estate | | 245,746 | | 595,732 | | 841,478 |
| Construction and land development | | 38,135 | | 151,803 | | 189,938 |
| Consumer | | 15,800 | | 9,208 | | 25,008 |
| Total | $ | 343,888 | $ | 807,448 | $ | 1,151,336 |

The following table presents information about the acquired PCI loans at the Bank Closing Date (in thousands).

| | | |
|---|---|---|
| Contractually required principal and interest payments | $ | 1,605,634 |
| Nonaccretable difference | | 567,861 |
| Cash flows expected to be collected | | 1,037,773 |

| | | |
|---|---|---|
| Accretable difference | | 230,325 |
| Fair value of covered loans acquired with a deterioration of credit quality | $ | 807,448 |

The following table presents information about the acquired performing loans at the Bank Closing Date (in thousands).

| | | |
|---|---|---|
| Contractually required principal and interest payments | $ | 555,057 |
| Contractual cash flows not expected to be collected | | 50,216 |
| Fair value at acquisition | | 343,888 |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

*PlainsCapital Merger*

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 PlainsCapital 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. For further information regarding goodwill recorded in connection with the PlainsCapital Merger, refer to Note 7, Goodwill and Other Intangible Assets.

The FNB Transaction is based on the purchase of assets and assumption of certain liabilities of FNB from the FDIC, as receiver. An essential part of the transaction is the Federal financial assistance governed by the P&A Agreement with the FDIC, which is not reflective of the previous operations of FNB. The nature and magnitude of the FNB Transaction, coupled with the Federal assistance, substantially reduces the relevance of historical financial information of FNB when considering the assessment of the historical financial information relative to future operations. Since the Company believes that the continuity of FNB s historical operations is substantially lacking after the transaction, no additional historical pro forma information regarding FNB is being provided below.

The following table presents pro forma results for the three and nine months ended September 30, 2012 had the PlainsCapital Merger taken place on January 1, 2011 (in thousands). The pro forma financial information combines the historical results of Hilltop and PlainsCapital, 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. 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, 2011. The pro forma results do not include any potential operating cost savings as a result of the PlainsCapital Merger. Further, certain costs associated with any restructuring or integration activities are also not reflected in the pro forma results. Pro forma results include any acquisition-related merger and restructuring charges incurred during the period. The pro forma results are not indicative of what would have occurred had the PlainsCapital Merger taken place on the indicated date.

| | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2012 |
|---|---|---|
| Net interest income | $ 57,212 | $ 164,980 |
| Other revenues | 247,764 | 641,201 |

| | | |
|---|---|---|
| Net income | 33,764 | 72,494 |

**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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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*

The Company 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 ). 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 September 30, 2013, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option was $1.05 billion, and the unpaid principal balance of those loans was $1.00 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, and 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.

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).

| September 30, 2013 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|---|---|---|---|---|
| Cash and cash equivalents | $ 1,016,274 | $ | $ | $ 1,016,274 |
| Trading securities | | 43,254 | | 43,254 |
| Available for sale securities | 20,996 | 1,198,783 | 59,602 | 1,279,381 |
| Loans held for sale | | 1,046,152 | | 1,046,152 |
| Derivative assets | | 32,967 | | 32,967 |
| Mortgage servicing asset | | | 13,401 | 13,401 |
| Trading liabilities | | 46 | | 46 |
| Derivative liabilities | | 28,375 | | 28,375 |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

| December 31, 2012 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|---|---|---|---|---|
| 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 |

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) | Total Gains or Losses (Realized or Unrealized) Included in Other Comprehensive Income (Loss) | Balance at End of Period |
|---|---|---|---|---|---|---|
| **Three months ended September 30, 2013** | | | | | | |
| Available for sale securities | $ 55,510 | $ | $ | $ | $ 4,092 | $ 59,602 |
| Mortgage servicing asset | 7,111 | | 4,079 | 2,211 | | 13,401 |
| Total | $ 62,621 | $ | $ 4,079 | $ 2,211 | $ 4,092 | $ 73,003 |
| | | | | | | |
| **Nine months ended September 30, 2013** | | | | | | |
| Available for sale securities | $ 56,277 | $ | $ | $ | $ 3,325 | $ 59,602 |
| Mortgage servicing asset | 2,080 | | 8,384 | 2,937 | | 13,401 |
| Total | $ 58,357 | $ | $ 8,384 | $ 2,937 | $ 3,325 | $ 73,003 |
| | | | | | | |
| **Three months ended September 30, 2012** | | | | | | |
| Available for sale securities | $ 54,577 | $ | $ | $ | $ 7,491 | $ 62,068 |
| Total | $ 54,577 | $ | $ | $ | $ 7,491 | $ 62,068 |
| | | | | | | |
| **Nine months ended September 30, 2012** | | | | | | |
| Available for sale securities | $ 60,377 | $ | $ | $ | $ 1,691 | $ 62,068 |
| Total | $ 60,377 | $ | $ | $ | $ 1,691 | $ 62,068 |

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 September 30, 2013. The available for sale securities noted in the tables above reflect Hilltop s

note receivable and warrant to purchase common stock of 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 September 30, 2013 | | | Three Months Ended September 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 | $ 44,395 | $ | $ 44,395 | $ | $ | $ |
| Mortgage servicing asset | 6,290 | | 6,290 | | | |
| Time deposits | | | | | | |

| | Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option | | | | | |
|---|---|---|---|---|---|---|
| | Nine Months Ended September 30, 2013 | | | Nine Months Ended September 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 | $ 2,754 | $ | $ 2,754 | $ | $ | $ |
| Mortgage servicing asset | 11,321 | | 11,321 | | | |
| Time deposits | | 12 | 12 | | | |

The Company also determines the fair value of certain assets and liabilities on a non-recurring basis. In particular, the fair value of all of the assets acquired and liabilities assumed in the FNB Transaction was determined at the Bank Closing Date. 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. The Company acquired PCI loans with a fair value of $172.9 million and $807.4 million 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. At September 30, 2013, non-covered PCI loans with a carrying amount of $139.2 million had been reduced by specific allowances within the allowance for non-covered loan losses of $3.0 million, resulting in a reported value of $136.2 million that approximates fair value. Covered PCI loans with a carrying amount of $782.6 million at September 30, 2013 approximated their fair value.

**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 primarily determines fair value using Level 2 inputs consisting of independent appraisals. In the FNB Transaction, the Bank acquired OREO of $121.0 million, all of which is covered by an FDIC loss-share agreement. At September 30, 2013, the estimated fair value of covered OREO was $119.7 million. The fair value of non-covered OREO at September 30, 2013 was $7.0 million and is included in other assets within the consolidated balance sheet.

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, except as follows.

**FDIC Indemnification Asset** The fair value of the FDIC Indemnification Asset is based on Level 3 inputs, including the discounted value of expected future cash flows under the loss-share agreements. The discount rate contemplates the credit worthiness of the FDIC as counterparty to this asset, and considers an incremental discount rate risk premium reflective of the inherent uncertainty associated with the timing of the cash flows.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The fair value of the assets acquired and liabilities assumed in the FNB Transaction was determined at Bank Closing Date. Given the short period of time that has elapsed between the Bank Closing Date and September 30, 2013, the fair value of the financial assets and liabilities shown at September 30, 2013 approximates their carrying values.

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 | | | |
|---|---|---|---|---|---|
| **September 30, 2013** | **Carrying Amount** | **Level 1 Inputs** | **Level 2 Inputs** | **Level 3 Inputs** | **Total** |
| Financial assets: | | | | | |
| Non-covered loans, net | $ 3,277,044 | $ | $ 286,663 | $ 3,018,250 | $ 3,304,913 |
| Covered loans | 1,096,590 | | | 1,096,590 | 1,096,590 |
| Broker-dealer and clearing organization receivables | 132,636 | | 132,636 | | 132,636 |
| FDIC indemnification asset | 190,041 | | | 190,041 | 190,041 |
| Other assets | 68,423 | | 51,134 | 17,289 | 68,423 |
| | | | | | |
| Financial liabilities: | | | | | |
| Deposits | 6,936,162 | | 6,936,527 | | 6,936,527 |
| Broker-dealer and clearing organization payables | 142,411 | | 142,411 | | 142,411 |
| Short-term borrowings | 305,297 | | 305,297 | | 305,297 |
| Debt | 207,123 | | 231,416 | | 231,416 |
| Other liabilities | 4,651 | | 4,651 | | 4,651 |

| | | Estimated Fair Value | | | |
|---|---|---|---|---|---|
| **December 31, 2012** | **Carrying Amount** | **Level 1 Inputs** | **Level 2 Inputs** | **Level 3 Inputs** | **Total** |
| Financial assets: | | | | | |
| Non-covered 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).

| September 30, 2013 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| U.S. Treasury securities | $ 23,746 | $ 86 | $ (17) | $ 23,815 |
| U.S. government agencies: | | | | |
| Bonds | 773,723 | 6,431 | (37,491) | 742,663 |
| Residential mortgage-backed securities | 62,825 | 1,462 | (499) | 63,788 |
| Collateralized mortgage obligations | 132,563 | 720 | (2,749) | 130,534 |
| Corporate debt securities | 73,566 | 5,071 | (276) | 78,361 |
| States and political subdivisions | 164,813 | 498 | (6,493) | 158,818 |
| Commercial mortgage-backed securities | 741 | 63 | | 804 |
| Equity securities | 19,756 | 1,240 | | 20,996 |
| Note receivable | 42,102 | 6,385 | | 48,487 |
| Warrant | 12,068 | | (953) | 11,115 |
| Totals | $ 1,305,903 | $ 21,956 | $ (48,478) | $ 1,279,381 |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

| December 31, 2012 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| 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).

| | September 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 | $ 17,709 | $ 17 | 2 | $ 2,427 | $ 2 |
| Unrealized loss for twelve months or longer | | | | | | |
| | 4 | 17,709 | 17 | 2 | 2,427 | 2 |
| U.S. government agencies: | | | | | | |
| Bonds: | | | | | | |
| Unrealized loss for less than twelve months | 38 | 560,938 | 37,491 | 14 | 236,305 | 314 |
| Unrealized loss for twelve months or longer | | | | | | |
| | 38 | 560,938 | 37,491 | 14 | 236,305 | 314 |
| Residential mortgage-backed securities: | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Unrealized loss for less than twelve months | 5 | 11,735 | 499 | 7 | 12,279 | 70 |
| Unrealized loss for twelve months or longer | | | | | | |
| | 5 | 11,735 | 499 | 7 | 12,279 | 70 |
| Collateralized mortgage obligations: | | | | | | |
| Unrealized loss for less than twelve months | 9 | 78,896 | 2,749 | 8 | 38,887 | 79 |
| Unrealized loss for twelve months or longer | | | | | | |
| | 9 | 78,896 | 2,749 | 8 | 38,887 | 79 |
| Corporate debt securities: | | | | | | |
| Unrealized loss for less than twelve months | 4 | 4,671 | 276 | | | |
| Unrealized loss for twelve months or longer | | | | | | |
| | 4 | 4,671 | 276 | | | |
| States and political subdivisions: | | | | | | |
| Unrealized loss for less than twelve months | 192 | 127,377 | 6,493 | 225 | 156,664 | 2,138 |
| Unrealized loss for twelve months or longer | | | | | | |
| | 192 | 127,377 | 6,493 | 225 | 156,664 | 2,138 |
| Warrants: | | | | | | |
| Unrealized loss for less than twelve months | 1 | 11,115 | 953 | | | |
| Unrealized loss for twelve months or longer | | | | | | |
| | 1 | 11,115 | 953 | | | |
| Total available for sale: | | | | | | |
| Unrealized loss for less than twelve months | 253 | 812,441 | 48,478 | 256 | 446,562 | 2,603 |
| Unrealized loss for twelve months or longer | | | | | | |
| | 253 | $ 812,441 | $ 48,478 | 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 nine months ended September 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 September 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 September 30, 2013 are shown by contractual maturity below (in thousands).

| | Amortized Cost | Fair Value |
|---|---|---|
| Due in one year or less | $ 44,895 | $ 45,076 |
| Due after one year through five years | 110,294 | 120,931 |
| Due after five years through ten years | 87,047 | 89,034 |
| Due after ten years | 835,714 | 797,103 |
| | 1,077,950 | 1,052,144 |
| | | |
| Residential mortgage-backed securities | 62,825 | 63,788 |
| Collateralized mortgage obligations | 132,563 | 130,534 |
| Commercial mortgage-backed securities | 741 | 804 |
| | $ 1,274,079 | $ 1,247,270 |

The Company realized a net gain from its trading securities portfolio of $0.1 million during the three months ended September 30, 2013 and a net loss of $2.6 million during the nine months ended September 30, 2013, which are recorded as a component of other noninterest income within the consolidated statements of operations.

Securities with a carrying amount of $928.7 million and $635.2 million (with a fair value of $884.6 million and $633.4 million) at September 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 September 30, 2013 and December 31, 2012, NLC had investments on deposit in custody for various state insurance departments with carrying values of $9.4 million and $9.3 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. The non-covered loan portfolio at September 30, 2013 includes loans acquired as a part of the FNB Transaction totaling $49.7 million, of which $17.6 million are categorized as non-covered PCI loans. Covered loans are discussed in Note 6 to the consolidated financial statements. Non-covered loans summarized by portfolio segment are as follows (in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Commercial and industrial | $ 1,625,422 | $ 1,660,293 |
| Real estate | 1,322,054 | 1,184,914 |
| Construction and land development | 310,392 | 280,483 |
| Consumer | 52,356 | 26,706 |
| | 3,310,224 | 3,152,396 |
| Allowance for non-covered loan losses | (33,180) | (3,409) |
| Total non-covered loans, net of allowance | $ 3,277,044 | $ 3,148,987 |

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 contractual balances of the non-covered PCI loans (in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Carrying amount | $ 139,224 | $ 166,780 |
| Outstanding balance | 187,370 | 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 non-covered PCI loans were as follows (in thousands).

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|---|---|
| Balance, beginning of period | $ 20,118 | $ 17,553 |
| Additions | 1,923 | 1,923 |
| Increases in expected cash flows | 4,697 | 16,834 |
| Disposals of loans | (441) | (2,273) |
| Accretion | (4,854) | (12,594) |
| Balance, end of period | $ 21,443 | $ 21,443 |

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 $1.1 million of additional non-covered impaired loans at September 30, 2013.

| September 30, 2013 | Unpaid Contractual Principal Balance | Nonaccretable Difference | Accretable Yield | Total Recorded Investment | Related Allowance |
|---|---|---|---|---|---|
| Commercial and industrial: | | | | | |
| Secured | $ 71,924 | $ 16,557 | $ 4,401 | $ 56,831 | $ 2,732 |
| Unsecured | 9,678 | 5,062 | 3,937 | 1,676 | |
| Real estate: | | | | | |
| Secured by commercial properties | 51,525 | 11,704 | 7,236 | 42,077 | 205 |
| Secured by residential properties | 6,141 | 1,140 | 904 | 4,636 | 73 |
| Construction and land development: | | | | | |
| Residential construction loans | | | | | |
| Commercial construction loans and land development | 35,012 | 9,637 | 3,940 | 24,641 | 1 |
| Consumer | 13,090 | 3,265 | 1,025 | 9,363 | |
| | $ 187,370 | $ 47,365 | $ 21,443 | $ 139,224 | $ 3,011 |

| December 31, 2012 | Unpaid Contractual Principal Balance | Nonaccretable Difference | Accretable Yield | Total Recorded Investment |
|---|---|---|---|---|
| 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 non-covered PCI loans is summarized by class in the following table (in thousands).

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|---|---|
| Commercial and industrial: | | |
| Secured | $ 55,797 | $ 62,399 |
| Unsecured | 1,826 | 2,548 |
| Real estate: | | |
| Secured by commercial properties | 45,114 | 48,798 |
| Secured by residential properties | 5,400 | 5,682 |
| Construction and land development: | | |
| Residential construction loans | | 354 |
| Commercial construction loans and land development | 25,916 | 28,502 |
| Consumer | 4,715 | 4,720 |
| | $ 138,768 | $ 153,003 |

Non-covered non-accrual loans at September 30, 2013, excluding those classified as held for sale, are summarized by class in the following table (in thousands).

| | |
|---|---|
| Commercial and industrial: | |
| Secured | $ 16,099 |
| Unsecured | 23 |
| Real estate: | |
| Secured by commercial properties | 1,856 |
| Secured by residential properties | 161 |
| Construction and land development: | |
| Residential construction loans | |
| Commercial construction loans and land development | 1,073 |
| Consumer | |
| | $ 19,212 |

At September 30, 2013, non-covered non-accrual loans included non-covered PCI loans of $18.1 million for which discount accretion has been suspended because the extent and timing of cash flows from these non-covered PCI loans can no longer be reasonably estimated. All non-covered PCI loans at December 31, 2012 were considered to be performing due to the application of the accretion method. In addition to the non-covered non-accrual loans in the table above, $2.7 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 September 30, 2013 and December 31, 2012, respectively.

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

The Bank 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. The Bank modifies loans by reducing interest rates and/or lengthening loan amortization schedules. The Bank 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 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Information regarding TDRs granted is shown in the following tables (in thousands). All TDRs granted relate to non-covered PCI loans. At September 30, 2013, the Bank had $0.3 million in unadvanced commitments to borrowers whose loans have been restructured in TDRs.

| | | Recorded Investment in Loans Modified by | | |
|---|---|---|---|---|
| **Three months ended September 30, 2013** | **A/B Note** | **Interest Rate Adjustment** | **Payment Term Extension** | **Total Modification** |
| Commercial and industrial: | | | | |
| Secured | $ | $ | $ 333 | $ 333 |
| 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 | | | | |
| | $ | $ | $ 333 | $ 333 |

| | | Recorded Investment in Loans Modified by | | |
|---|---|---|---|---|
| **Nine months ended September 30, 2013** | **A/B Note** | **Interest Rate Adjustment** | **Payment Term Extension** | **Total Modification** |
| Commercial and industrial: | | | | |
| Secured | $ | $ | $ 9,764 | $ 9,764 |
| Unsecured | | | | |
| Real estate: | | | | |
| Secured by commercial properties | | | 276 | 276 |
| Secured by residential properties | | | 905 | 905 |
| Construction and land development: | | | | |
| Residential construction loans | | | | |
| Commercial construction loans and land development | | | 500 | 500 |
| Consumer | | | | |
| | $ | $ | $ 11,445 | $ 11,445 |

An analysis of the aging of the Bank s non-covered loan portfolio is shown in the following tables (in thousands).

| **September 30, 2013** | **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** |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Commercial and industrial: | | | | | | | | |
| Secured | $ 1,099 | $ 1,065 | $ 1,395 | $ 3,559 | $ 1,451,740 | $ 56,831 | $ 1,512,130 | $ 1,118 |
| Unsecured | 475 | 1,339 | 23 | 1,837 | 109,779 | 1,676 | 113,292 | |
| Real estate: | | | | | | | | |
| Secured by commercial properties | | 132 | | 132 | 1,004,464 | 42,077 | 1,046,673 | |
| Secured by residential properties | 698 | 20 | | 718 | 270,027 | 4,636 | 275,381 | |
| Construction and land development: | | | | | | | | |
| Residential construction loans | | | | | 57,205 | | 57,205 | |
| Commercial construction loans and land development | | 112 | | 112 | 228,434 | 24,641 | 253,187 | |
| Consumer | 101 | 21 | 10 | 132 | 42,861 | 9,363 | 52,356 | 10 |
| | $ 2,373 | $ 2,689 | $ 1,428 | $ 6,490 | $ 3,164,510 | $ 139,224 | $ 3,310,224 | $ 1,128 |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Commercial and industrial: | | | | | | | | |
| Unsecured | 3 | | | 3 | 105,339 | 3,419 | 108,761 | |
| Secured by commercial properties | 714 | | | 714 | 868,070 | 55,519 | 924,303 | |
| Construction and land development: | | | | | | | | |
| Commercial construction loans and land development | 63 | | | 63 | 199,889 | 32,362 | 232,314 | |
| | $ 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.

The Bank 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

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

| September 30, 2013 | Pass | Special Mention | Substandard | PCI | Total |
|---|---|---|---|---|---|
| Commercial and industrial: | | | | | |
| Secured | $ 1,430,645 | $ 6,269 | $ 18,385 | $ 56,831 | $ 1,512,130 |
| Unsecured | 111,381 | 13 | 222 | 1,676 | 113,292 |
| Real estate: | | | | | |
| Secured by commercial properties | 1,003,771 | 505 | 320 | 42,077 | 1,046,673 |
| Secured by residential properties | 266,949 | | 3,796 | 4,636 | 275,381 |
| Construction and land development: | | | | | |
| Residential construction loans | 57,205 | | | | 57,205 |
| Commercial construction loans and land development | 227,192 | 874 | 480 | 24,641 | 253,187 |
| Consumer | 42,950 | 32 | 11 | 9,363 | 52,356 |
| | $ 3,140,093 | $ 7,693 | $ 23,214 | $ 139,224 | $ 3,310,224 |

| December 31, 2012 | Pass | Special Mention | Substandard | PCI | Total |
|---|---|---|---|---|---|
| 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 PlainsCapital Merger on November 30, 2012, the Bank 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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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 September 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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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

| Three months ended September 30, 2013 | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total |
|---|---|---|---|---|---|
| Balance, beginning of period | $ 13,806 | $ 5,339 | $ 7,050 | $ 42 | $ 26,237 |
| Provision charged to operations | 8,879 | 1,776 | 6 | (3) | 10,658 |
| Loans charged off | (3,220) | (53) | (524) | (3) | (3,800) |
| Recoveries on charged off loans | 42 | 26 | 2 | 15 | 85 |
| Balance, end of period | $ 19,507 | $ 7,088 | $ 6,534 | $ 51 | $ 33,180 |

| Nine months ended September 30, 2013 | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total |
|---|---|---|---|---|---|
| Balance, beginning of period | $ 1,845 | $ 977 | $ 582 | $ 5 | $ 3,409 |
| Provision charged to operations | 22,519 | 6,033 | 6,323 | 77 | 34,952 |
| Loans charged off | (7,314) | (149) | (524) | (74) | (8,061) |
| Recoveries on charged off loans | 2,457 | 227 | 153 | 43 | 2,880 |
| Balance, end of period | $ 19,507 | $ 7,088 | $ 6,534 | $ 51 | $ 33,180 |

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

| September 30, 2013 | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total |
|---|---|---|---|---|---|
| Loans individually evaluated for impairment | $ 940 | $ 161 | $ | $ | $ 1,101 |
| Loans collectively evaluated for impairment | 1,565,975 | 1,275,180 | 285,751 | 42,993 | 3,169,899 |
| PCI Loans individually evaluated for impairment | 58,507 | 46,713 | 24,641 | 9,363 | 139,224 |
| | $ 1,625,422 | $ 1,322,054 | $ 310,392 | $ 52,356 | $ 3,310,224 |

| December 31, 2012 | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total |
|---|---|---|---|---|---|
| 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 |

The allowance for non-covered loan losses was distributed by portfolio segment and impairment methodology as shown below (in thousands).

| September 30, 2013 | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total |
|---|---|---|---|---|---|
| Loans individually evaluated for impairment | $ | $ | $ | $ | $ |
| Loans collectively evaluated for impairment | 16,775 | 6,810 | 6,533 | 51 | 30,169 |
| PCI Loans individually evaluated for impairment | 2,732 | 278 | 1 | | 3,011 |
| | $ 19,507 | $ 7,088 | $ 6,534 | $ 51 | $ 33,180 |

| December 31, 2012 | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total |
|---|---|---|---|---|---|
| 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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(Unaudited)

**6. Covered Assets and Indemnification Asset**

As discussed in Note 2 to the consolidated financial statements, the Bank assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of FNB in an FDIC-assisted transaction on September 13, 2013. As part of the loss-share agreements entered into by the Bank with the FDIC in connection therewith, the Bank and the FDIC agreed to share the losses on loans and OREO covered under the agreements. The asset arising from the loss-share agreements, which we refer to as the FDIC Indemnification Asset is measured separately from the covered loan portfolio because the agreements are not contractually embedded in the covered loans and are not transferable should the Bank choose to dispose of the covered loans.

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.

**Covered Loans and Allowance for Covered Loan Losses**

Loans acquired in a FDIC-assisted acquisition that are subject to a loss-share agreement are referred to as covered loans and reported separately in our consolidated balance sheets. Covered loans are reported exclusive of the cash flow reimbursements that may be received from the FDIC.

Based on preliminary purchase date valuations, the Bank s portfolio of acquired covered loans had a fair value of $1.1 billion as of the Bank Closing Date, with no carryover of any allowance for loan losses. Acquired covered loans were preliminarily segregated between those considered to be PCI loans and those deemed performing.

In connection with the FNB Transaction, the Bank acquired loans both with and without evidence of credit quality deterioration since origination. The Company s accounting policies for acquired covered loans, including covered PCI loans, are consistent with that of acquired non-covered loans, as described in Note 5 to the consolidated financial statements. The Company has established under its PCI accounting policy a framework to aggregate certain acquired covered loans into various loan pools based on a minimum of two layers of common risk characteristics for the purpose of determining their respective fair values as of their acquisition dates, and for applying the subsequent recognition and measurement provisions for income accretion and impairment testing.

The following table presents the carrying value of the covered loans summarized by portfolio segment at September 30, 2013 (in thousands).

| | | |
|---|---|---|
| Commercial and industrial | $ | 74,581 |
| Real estate | | 833,493 |
| Construction and land development | | 188,505 |
| Consumer | | 11 |
| Total covered loans | $ | 1,096,590 |

The following table presents the carrying value and the outstanding contractual balance of the covered PCI loans at September 30, 2013 (in thousands).

| | | |
|---|---|---|
| Carrying amount | $ | 782,560 |
| Oustanding balance | | 1,082,315 |

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At September 30, 2013, the preliminary total nonaccretable difference and accretable yield for covered PCI loans were $561.7 million and $226.8 million, respectively. The change in the accretable yield for the covered PCI loans for the period from September 14, 2013 through September 30, 2013 included accretion of the discount on loans of $0.1 million, which was recorded as a component of interest income within the consolidated statements of operations.

Interest income recorded on non-accrual covered loans was nominal. All covered PCI loans are considered to be performing due to the application of the accretion method. Additionally, no acquired covered loans have been modified in a TDR.

An analysis of the aging of the Bank s covered loan portfolio at September 30, 2013 is shown in the following table (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 |
|---|---|---|---|---|---|---|---|---|
| Commercial and industrial: | | | | | | | | |
| Secured | $ 54 | $ | $ | $ 54 | $ 28,529 | $ 34,994 | $ 63,577 | $ |
| Unsecured | | | | | 2,854 | 8,150 | 11,004 | |
| Real estate: | | | | | | | | |
| Secured by commercial properties | 37 | | | 37 | 80,627 | 373,849 | 454,513 | |
| Secured by residential properties | | | | | 163,514 | 215,466 | 378,980 | |
| Construction and land development: | | | | | | | | |
| Residential construction loans | | | | | 6,490 | 4,651 | 11,141 | |
| Commercial construction loans and land development | | | | | 31,914 | 145,450 | 177,364 | |
| Consumer | | | | | 11 | | 11 | |
| | $ 91 | $ | $ | $ 91 | $ 313,939 | $ 782,560 | $ 1,096,590 | $ |

The Bank assigns a risk grade to each of its covered loans in a manner consistent with the existing loan review program and risk grading matrix used for non-covered loans, as described in Note 5 to the consolidated financial statements. However, given the short period of time that has elapsed between the Bank Closing Date and September 30, 2013, the Bank s assessment of individual loan factors and assignment of an internal risk grade to each of the loans in its covered loan portfolio is preliminary.

The Bank s impairment methodology for the covered loans is consistent with that of non-covered loans as discussed in Note 5 to the consolidated financial statements. To the extent there is experienced or projected credit deterioration on the acquired covered loan pools subsequent to amounts estimated at the previous quarterly recast date, this deterioration will be measured, and a provision for credit losses will be charged to earnings. Additionally, provision for credit losses will be recorded on advances on covered loans subsequent to the acquisition date in a manner consistent with the allowance for non-covered loan losses. These provisions will be partially offset by an increase to the FDIC Indemnification Asset in an amount equal to the FDIC s loss sharing percentage under the loss-share agreements, which is recognized in noninterest income within the consolidated statement of operations.

There were no specific reserves in the allowance for loan losses related to covered loans at September 30, 2013.

**Covered Other Real Estate Owned**

At September 30, 2013, covered OREO was $119.7 million. Between the Bank Closing Date and September 30, 2013, the Company sold covered OREO properties with a carrying amount of $1.3 million, substantially at book value.

**FDIC Indemnification Asset**

At September 30, 2013, the FDIC Indemnification Asset was $190.0 million. The Company recorded accretion of $0.3 million since acquisition, which was included as a component of other noninterest income within the consolidated statements of operations.

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**7. Goodwill and Other Intangible Assets**

The carrying amount of goodwill was $251.8 million and $253.8 million at September 30, 2013 and December 31, 2012, respectively. The Company initially recorded $230.1 million of goodwill in connection with the PlainsCapital Merger, and used significant estimates and assumptions to value the identifiable assets acquired and liabilities assumed. The amount of goodwill recorded in connection with the PlainsCapital Merger is not deductible for tax purposes. During the three months ended March 31, 2013, the Company reduced goodwill related to the PlainsCapital Merger by $2.0 million for a purchase accounting adjustment related to the valuation of a capital lease obligation. The Company made no further adjustments to its purchase price allocation.

Other intangible assets of $75.9 million and $77.7 million at September 30, 2013 and December 31, 2012, respectively, include an indefinite lived intangible asset with an estimated fair value of $3.0 million related to state licenses acquired as a part of the NLC acquisition in January 2007. In addition, as discussed in Note 2 to the consolidated financial statements, the Company recorded a $6.4 million preliminary core deposits intangible asset during September 2013 in connection with the FNB Transaction, which will be amortized on an accelerated basis over approximately seven years.

The Company tests goodwill and other intangible assets having an indefinite useful life for impairment on an annual basis, or more often if events or circumstances indicate there may be impairment. Goodwill impairment testing is performed at the reporting unit level, which is one level below an operating segment. Goodwill is assigned to reporting units at the date the goodwill is initially recorded. Once goodwill has been assigned to reporting units, it no longer retains its association with a particular acquisition, and all of the activities within a reporting unit, whether acquired or internally generated, are available to support the value of the goodwill. The Company performs required annual impairment tests of its goodwill and other intangible assets as of December 31st for its insurance reporting unit, while the acquired banking, mortgage origination and financial advisory reporting units will be tested for impairment annually as of October 1st.

**8. Deposits**

Deposits are summarized as follows (in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Noninterest-bearing demand | $ 392,404 | $ 323,367 |
| Interest-bearing: | | |
| NOW accounts | 179,805 | 106,562 |
| Money market | 2,936,579 | 2,357,109 |

| | | | | |
|---|---|---|---|---|
| Brokered - money market | | 280,354 | | 263,193 |
| Demand | | 53,558 | | 75,308 |
| Savings | | 450,723 | | 180,367 |
| Time | | 2,402,485 | | 1,175,432 |
| Brokered - time | | 240,254 | | 219,123 |
| | $ | 6,936,162 | $ | 4,700,461 |

The significant increase in deposits at September 30, 2013 as compared to December 31, 2012 is primarily due to the inclusion of $2.2 billion of deposits assumed as a part of the FNB Transaction.

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**9. Short-term Borrowings**

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

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Federal funds purchased | $ 91,875 | $ 269,625 |
| Securities sold under agreements to repurchase | 121,222 | 85,725 |
| Federal Home Loan Bank notes | | 250,000 |
| Short-term bank loans | 92,200 | 122,900 |
| | $ 305,297 | $ 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).

| | Nine Months Ended September 30, 2013 |
|---|---|
| Average balance during the period | $ 284,819 |
| Average interest rate during the period | 0.19% |

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Average interest rate at end of period | 0.14% | 0.22% |
| Securities underlying the agreements at end of period | | |
| Carrying value | $ 152,808 | $ 122,153 |
| Estimated fair value | $ 146,197 | $ 122,435 |

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).

| | Nine Months Ended September 30, 2013 |
|---|---|
| Average balance during the period | $ 142,274 |
| Average interest rate during the period | 0.13% |

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Average interest rate at end of period | 0.00% | 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 September 30, 2013 and December 31, 2012 was 1.09% and 1.16%, respectively.

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(Unaudited)

**10. Income Taxes**

The Company 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 33.3% and 35.5% for the three and nine months ended September 30, 2013, respectively. During the three and nine months ended September 30, 2012, the Company recorded income tax benefits due to the loss from operations which reflected effective rates of 32.1% and 32.5%, 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 September 30, 2013 and 2012. The Company does not anticipate any significant liabilities for uncertain tax positions to arise in the next twelve months.

The Company files income tax returns in U.S. federal and several U.S. state jurisdictions. The Company 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 PlainsCapital Merger, the Company 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 September 30, 2013. PlainsCapital 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 September 30, 2013.

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

**11. 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 and its subsidiaries are a party to various legal actions resulting from our operating activities. These actions consist of litigation and administrative proceedings arising in the ordinary course of business, some of which are covered by liability insurance, and none of which is expected to have a material adverse effect on the Company s 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. The mortgage origination segment has established an indemnification liability reserve for such probable losses.

Generally, the mortgage origination segment first becomes aware that an investor believes a loss has been incurred on a sold loan when it receives a written request from the investor to repurchase the loan or reimburse the investor s losses. Upon completing its review of the investor s request, the mortgage origination segment establishes a specific claims reserve for the loan if it concludes its obligation to the investor is both probable and reasonably estimable.

An additional reserve has been established for probable investor losses that may have been incurred, but not yet reported to the mortgage origination segment based upon a reasonable estimate of such losses. Factors considered in the calculation of this reserve include, but are not limited to, the total volume of loans sold exclusive of specific investor requests, actual

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(Unaudited)

investor claim settlements and the severity of estimated losses resulting from future claims, and our history of successfully curing defects identified in investor claim requests. While the mortgage origination segment s sales contracts typically include borrower early payment default repurchase provisions, these provisions have not been a primary driver of investor claims to date, and therefore, are not a primary factor considered in the calculation of this reserve.

At September 30, 2013, and December 31, 2012, the mortgage origination segment s indemnification liability reserve totaled $21.0 million and $19.0 million, respectively. The provision for indemnification losses was $0.9 million and $2.8 million for the three and nine months ended September 30, 2013, respectively.

The following tables provide for a roll-forward of claims activity for loans put-back to the mortgage origination segment based upon an alleged breach of a representation or warranty with respect to a loan sold and related indemnification liability reserve activity (in thousands).

| | Representation and Warranty Specific Claims Activity - Origination Loan Balance | |
|---|---|---|
| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
| Balance, beginning of period | $ 46,090 | $ 39,693 |
| Claims made | 6,769 | 25,844 |
| Claims resolved with no payment | (2,338) | (10,751) |
| Repurchases | (1,597) | (3,917) |
| Indemnification payments | (542) | (2,487) |
| Balance, end of period | $ 48,382 | $ 48,382 |

| | Indemnification Liability Reserve Activity | |
|---|---|---|
| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
| Balance, beginning of period | $ 20,397 | $ 18,964 |
| Additions for new sales | 878 | 2,834 |
| Repurchases | (120) | (129) |
| Early payment defaults | (165) | (397) |
| Indemnification payments | (177) | (701) |
| Change in estimate | 214 | 456 |
| Balance, end of period | $ 21,027 | $ 21,027 |
| | | |
| Reserve for Indemnification Liability: | | |
| Specific claims | $ 12,336 | |
| Incurred but not reported claims | 8,691 | |
| Total | $ 21,027 | |

Although management considers the total indemnification liability reserve to be appropriate, there may be changes in the reserve over time to address incurred losses, 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 impact of such matters is considered in the reserving process when probable and estimable.

In connection with the FNB Transaction, the Bank entered into two loss-share agreements with the FDIC that collectively cover approximately $1.2 billion of loans and OREO acquired in the FNB Transaction. Pursuant to the loss-share agreements, the FDIC has agreed to reimburse the Bank the following amounts with respect to the covered assets: (i) 80% of losses on the first $240.4 million of losses incurred; (ii) 0% of losses in excess of $240.4 million up to and including $365.7 million of losses incurred; and (iii) 80% of losses in excess of $365.7 million of losses incurred. The Bank has also agreed to reimburse the FDIC for any subsequent recoveries. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, from the Bank Closing Date and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. In accordance

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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.

**12. 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 $1.2 billion at September 30, 2013 and outstanding standby letters of credit of $37.8 million at September 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.

**13. 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 the Company, its subsidiaries and outside directors of the Company. 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 September 30, 2013, unrecognized compensation expense related to these Restricted Stock Awards was $5.3 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.

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During the nine months ended September 30, 2013, the Company granted 6,504 shares of common stock to members of our board of directors as compensation for director services pursuant to the 2012 Plan.

At September 30, 2013, 3,528,496 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 September 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 September 30, 2013, unrecognized compensation expense related to these Stock Option Awards was $0.2 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 2012 Plan and 2003 Plan was $0.6 million and $0.1 million for the three months ended September 30, 2013 and 2012, respectively. For the nine months ended September 30, 2013 and 2012, compensation expense related to the plans was $1.1 million and $0.4 million, respectively.

**14. 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.

During September 2013, Hilltop and PlainsCapital contributed capital of $35.0 million and $25.0 million, respectively, to the Bank to provide additional capital in connection with the FNB Transaction.

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The following table shows the Bank s and Hilltop s consolidated actual capital amounts and ratios compared to the regulatory minimum capital requirements and the Bank s regulatory minimum capital requirements needed to qualify as a well-capitalized institution (dollars in thousands), without giving effect to the final Basel III capital rules adopted by the Federal Reserve Board on July 2, 2013.

| | Actual | | Minimum Capital Requirements | | To Be Well Capitalized Minimum Capital Requirements | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **September 30, 2013** | | | | | | |
| Tier 1 capital (to average assets): | | | | | | |
| Bank | $ 724,382 | 11.05% | $ 262,134 | 4% | $ 327,668 | 5% |
| Hilltop | 986,507 | 13.96% | 282,603 | 4% | N/A | N/A |
| Tier 1 capital (to risk-weighted assets): | | | | | | |
| Bank | 724,382 | 12.76% | 227,101 | 4% | 274,961 | 6% |
| Hilltop | 986,507 | 16.56% | 238,347 | 4% | N/A | N/A |
| Total capital (to risk-weighted assets): | | | | | | |
| Bank | 758,753 | 13.36% | 454,203 | 8% | 567,753 | 10% |
| Hilltop | 1,021,436 | 17.14% | 476,695 | 8% | N/A | N/A |
| | | | | | | |
| **December 31, 2012** | | | | | | |
| Tier 1 capital (to average assets): | | | | | | |
| Bank | $ 542,307 | 8.84% | $ 245,495 | 4% | $ 306,869 | 5% |
| Hilltop | 871,379 | 13.08% | 266,514 | 4% | N/A | N/A |
| Tier 1 capital (to risk-weighted assets): | | | | | | |
| Bank | 542,307 | 11.83% | 183,308 | 4% | 274,961 | 6% |
| Hilltop | 871,379 | 17.72% | 196,670 | 4% | N/A | N/A |
| Total capital (to risk-weighted assets): | | | | | | |
| Bank | 546,598 | 11.93% | 366,615 | 8% | 458,269 | 10% |
| Hilltop | 875,670 | 17.81% | 393,340 | 8% | N/A | N/A |

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 table, the Bank s ratios place it in the well capitalized (as defined) capital category under regulatory requirements.

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 September 30, 2013, FSC had net capital of $69.8 million (the minimum net capital requirement was $3.8 million), net capital maintained by FSC was 37% of aggregate debits, and net capital in excess of the minimum requirement was $66.0 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 September 30, 2013 or December 31, 2012.

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*Mortgage Origination*

As a mortgage originator, PrimeLending is subject to minimum net worth requirements established by the United States Department of Housing and Urban Development ( HUD ) and the Government National Mortgage Association ( GNMA ). On an annual basis, PrimeLending submits audited financial statements to HUD and GNMA documenting PrimeLending s compliance with its minimum net worth requirements. In addition, PrimeLending monitors compliance on an ongoing basis and, as of September 30, 2013, PrimeLending s net worth exceeded the amounts required by both HUD and GNMA.

*Insurance*

The statutory financial statements of the Company s insurance subsidiaries, which are domiciled in the State of Texas, are presented on the basis of accounting practices prescribed or permitted by the Texas Department of Insurance. Texas has adopted the National Association of Insurance Commissioners ( NAIC ) statutory accounting practices as the basis of its statutory accounting practices with certain differences that are not significant to the insurance company subsidiaries statutory equity.

A summary of statutory capital and surplus and statutory net income (loss) of each insurance subsidiary is as follows (in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Capital and surplus: | | |
| National Lloyds Insurance Company | $ 87,723 | $ 94,558 |
| American Summit Insurance Company | 24,946 | 25,761 |

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Statutory net income (loss): | | | | |
| National Lloyds Insurance Company | $ 2,645 | $ (1,759) | $ (7,296) | $ (9,516) |
| American Summit Insurance Company | 167 | (136) | (962) | (706) |

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At September 30, 2013, the Company s insurance subsidiaries had statutory surplus in excess of the minimum required.

The NAIC has adopted a risk based capital ( RBC ) formula for insurance companies that establishes minimum capital requirements indicating various levels of available regulatory action on an annual basis relating to insurance risk, asset credit risk, interest rate risk and business risk. The RBC formula is used by the NAIC and certain state insurance regulators as an early warning tool to identify companies that require additional scrutiny or regulatory action. At December 31, 2012, the most recent date for which the RBC calculation was performed, the Company s insurance subsidiaries RBC ratio exceeded the level at which regulatory action would be required. As of September 30, 2013, management was not aware of any changes in financial condition or structure that would cause the Company s insurance subsidiaries to not be in compliance with the required RBC ratio.

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(Unaudited)

**15. Derivative Financial Instruments**

The Company uses various derivative financial instruments to mitigate interest rate risk. The Bank s interest rate risk management strategy involves effectively modifying the re-pricing characteristics of certain assets and liabilities so that changes in interest rates do not adversely affect the net interest margin. PrimeLending has interest rate risk relative to interest rate lock commitments ( IRLCs ) and its inventory of mortgage loans held for sale. PrimeLending is exposed to such rate risk from the time an IRLC is made to an applicant to the time the related mortgage loan is sold. To mitigate interest rate risk, PrimeLending executes forward commitments to sell mortgage-backed securities ( MBSs ). FSC uses forward commitments to both purchase and sell MBSs to facilitate customer transactions and as a means to manage risk in certain inventory positions.

*Non-Hedging Derivative Instruments and the Fair Value Option*

As discussed in Note 3 to the consolidated financial statements, the Company has elected to measure substantially all mortgage loans held for sale at fair value under the provisions of the Fair Value Option. The election provides the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without applying complex hedge accounting provisions. The fair values of PrimeLending s IRLCs and forward commitments are recorded in other assets or other liabilities, as appropriate, and changes in the fair values of these derivative instruments produced net losses of $48.9 million and $14.9 million for the three and nine months ended September 30, 2013, respectively, which were recorded as a component of net gains from sale of loans and other mortgage production income. The change in fair value during the three months ended September 30, 2013, is attributable to a decrease in the volume of IRLC s and mortgage loans held for sale, which also conversely affected the value of PrimeLending s mortgage loans held for sale, which are measured at fair value under the Fair Value Option. The effect of the change in market interest rates on PrimeLending s loans held for sale is discussed in Note 3 to the consolidated financial statements. The fair values of FSC s derivative instruments are recorded in other assets or other liabilities, as appropriate, and changes in the fair values of FSC s derivatives produced net gains of $3.2 million and $8.8 million for the three and nine months ended September 30, 2013, respectively, which were recorded as a component of other noninterest income.

Derivative positions are presented in the following table (in thousands).

| | September 30, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Notional Amount | Estimated Fair Value | Notional Amount | Estimated Fair Value |
| Derivative instruments: | | | | |
| IRLCs | $ 798,837 | $ 26,440 | $ 968,083 | $ 15,150 |
| Commitments to purchase MBSs | 283,437 | 7,443 | 165,128 | 466 |
| Interest rate swaps | | | 1,969 | 25 |
| Commitments to sell MBSs | 1,826,399 | (29,290) | 1,586,930 | (1,025) |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**16. Balance Sheet Offsetting**

Certain financial instruments, including resale and repurchase agreements, securities lending arrangements and derivatives, may be eligible for offset in the consolidated balance sheet and/or subject to master netting arrangements or similar agreements.

The following tables present the assets and liabilities subject to an enforceable master netting arrangement, repurchase agreements, or similar agreements with offsetting rights at September 30, 2013 and December 31, 2012 (in thousands).

| | Gross Amounts of Recognized Assets | Gross Amounts Offset in the Balance Sheet | Net Amounts of Assets Presented in the Balance Sheet | Gross Amounts Not Offset in the Balance Sheet | | Net Amount |
|---|---|---|---|---|---|---|
| | | | | Financial Instruments | Cash Collateral Pledged | |
| **September 30, 2013** | | | | | | |
| Securities Borrowed: | | | | | | |
| Institutional Counterparties | $ 100,348 | $ | $ 100,348 | $ (100,348) | $ | $ |
| | $ 100,348 | $ | $ 100,348 | $ (100,348) | $ | $ |
| | | | | | | |
| **December 31, 2012** | | | | | | |
| Securities Borrowed: | | | | | | |
| Institutional Counterparties | $ 103,936 | $ | $ 103,936 | $ (103,936) | $ | $ |
| | $ 103,936 | $ | $ 103,936 | $ (103,936) | $ | $ |

| | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Balance Sheet | Net Amounts of Liabilities Presented in the Balance Sheet | Gross Amounts Not Offset in the Balance Sheet | | Net Amount |
|---|---|---|---|---|---|---|
| | | | | Financial Instruments | Cash Collateral Pledged | |
| **September 30, 2013** | | | | | | |
| Securities Loaned: | | | | | | |
| Institutional Counterparties | $ 70,769 | $ | $ 70,769 | $ (70,769) | $ | $ |
| | | | | | | |
| Repurchase Agreements: | | | | | | |
| Customer Counterparties | 121,222 | | 121,222 | (121,222) | | |
| | | | | | | |
| Forward MBS Sale Derivatives: | | | | | | |
| Institutional Counterparties | 29,389 | (100) | 29,289 | | (21,858) | 7,431 |
| | $ 221,380 | $ (100) | $ 221,280 | $ (191,991) | $ (21,858) | $ 7,431 |
| | | | | | | |
| **December 31, 2012** | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Securities Loaned: | | | | | | |
| Institutional Counterparties | $ 115,102 | $ | $ 115,102 | $ (115,102) | $ | $ |
| | | | | | | |
| Repurchase Agreements: | | | | | | |
| Customer Counterparties | 85,726 | | 85,726 | (85,726) | | |
| | | | | | | |
| Forward MBS Sale Derivatives: | | | | | | |
| Institutional Counterparties | 2,000 | (975) | 1,025 | | (249) | 776 |
| | $ 202,828 | $ (975) | $ 201,853 | $ (200,828) | $ (249) | $ 776 |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**17. Broker-Dealer and Clearing Organization Receivables and Payables**

Broker-dealer and clearing organization receivables and payables consisted of the following (in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Receivables: | | |
| Securities borrowed | $ 100,348 | $ 103,936 |
| Securities failed to deliver | 21,442 | 33,045 |
| Clearing organizations | 10,842 | 8,543 |
| Due from dealers | 4 | 40 |
| | $ 132,636 | $ 145,564 |
| | | |
| Payables: | | |
| Securities loaned | $ 70,769 | $ 115,102 |
| Correspondents | 43,550 | 41,414 |
| Securities failed to receive | 24,888 | 31,474 |
| Clearing organizations | 3,204 | |
| | $ 142,411 | $ 187,990 |

**18. Reserves for Unpaid Losses and Loss Adjustment Expenses**

Information regarding the reserve for unpaid losses and losses and loss adjustment expenses ( LAE ) are as follows (in thousands).

| | Nine Months Ended September 30, 2013 | 2012 |
|---|---|---|
| Balance, beginning of period | $ 34,012 | $ 44,835 |
| Less reinsurance recoverables | (10,385) | (25,083) |
| Net balance, beginning of period | 23,627 | 19,752 |
| | | |
| Incurred related to: | | |
| Current period | 93,124 | 90,928 |
| Prior periods | 852 | 821 |
| Total incurred | 93,976 | 91,749 |
| | | |
| Payments related to: | | |

| | | | | |
|---|---|---|---|---|
| Current period | | (78,742) | | (73,267) |
| Prior periods | | (13,623) | | (13,194) |
| Total payments | | (92,365) | | (86,461) |
| | | | | |
| Net balance, end of period | | 25,238 | | 25,040 |
| Plus reinsurance recoverables | | 6,029 | | 20,995 |
| Balance, end of period | $ | 31,267 | $ | 46,035 |

The decrease in the reserves at September 30, 2013 as compared to September 30, 2012 of $14.8 million is primarily due to the significant subsequent payment and recovery of those reinsurance recoverables outstanding at September 30, 2012.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**19. Reinsurance Activity**

NLC limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risk. Substantial amounts of business are ceded, and these reinsurance contracts do not relieve NLC from its obligations to policyholders. Such reinsurance includes quota share, excess of loss, catastrophe, and other forms of reinsurance on essentially all property and casualty lines of insurance. Net insurance premiums earned, losses and LAE and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE and unearned insurance premiums ceded to them are reported as assets. Failure of reinsurers to honor their obligations could result in losses to NLC; consequently, allowances are established for amounts deemed uncollectible as NLC evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At September 30, 2013, reinsurance receivables had a carrying value of $7.7 million. There was no allowance for uncollectible accounts at September 30, 2013, based on our quality requirements.

The effects of reinsurance on premiums written and earned are summarized as follows (in thousands).

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2013 | | 2012 | | 2013 | | 2012 | |
| | Written | Earned | Written | Earned | Written | Earned | Written | Earned |
| Premiums from direct business | $ 44,484 | $ 43,031 | $ 40,899 | $ 40,922 | $ 134,292 | $ 125,520 | $ 126,833 | $ 121,209 |
| Reinsurance assumed | 2,058 | 1,860 | 1,726 | 1,520 | 5,931 | 5,238 | 4,830 | 4,296 |
| Reinsurance ceded | (5,100) | (4,909) | (5,106) | (4,754) | (14,879) | (14,713) | (14,953) | (16,467) |
| Net premiums | $ 41,442 | $ 39,982 | $ 37,519 | $ 37,688 | $ 125,344 | $ 116,045 | $ 116,710 | $ 109,038 |

The effects of reinsurance on incurred losses are as follows (in thousands).

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Loss and LAE incurred | $ 27,558 | $ 31,577 | $ 98,507 | $ 94,022 |
| Reinsurance recoverables | (2,927) | (1,441) | (4,531) | (2,273) |
| Net loss and LAE incurred | $ 24,631 | $ 30,136 | $ 93,976 | $ 91,749 |

**Multi-line excess of loss coverage**

For all lines of business, NLC has excess of loss reinsurance covering $700,000 in excess of $300,000 retention on losses on any one risk.

**Catastrophic coverage**

NLC has catastrophic excess of loss reinsurance coverage of losses per event in excess of $8 million retention by NLIC and $1.5 million retention by ASIC. ASIC maintains an underlying layer of coverage, providing $6.5 million in excess of its $1.5 million retention to bridge to the primary program. The reinsurance in excess of $8 million is comprised of four layers of protection: $17 million in excess of $8 million retention; $25 million in excess of $25 million loss; $50 million in excess of $50 million loss and $40 million ($70 million through June 30, 2013) in excess of $100 million loss. NLIC and ASIC retain no participation in any of the layers, beyond the first $8 million and $1.5 million, respectively. At September 30, 2013, total retention for any one catastrophe that affects both NLIC and ASIC was limited to $8 million in the aggregate.

Effective July 1, 2013, NLC renewed its catastrophic reinsurance contract for its third and fourth layers of reinsurance for a two year period. In the contract renewal, the coverage provided by the fourth layer changed to reflect the reduction of exposure in Texas primarily as a result of NLIC exiting the Texas coast and reducing its exposure in Harris County, Texas. The coverage provides $40 million in excess of $100 million loss, resulting in catastrophic excess of loss reinsurance coverage up to $140 million.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**20. Segment and Related Information**

The Company has four reportable segments that are organized primarily by the core products offered to the segments respective customers. The banking segment includes the operations of the Bank. The operations of PrimeLending comprise the mortgage origination segment. The insurance segment is composed of NLC. The financial advisory segment is composed of First Southwest.

Balance sheet amounts for Hilltop and its remaining subsidiaries not discussed in the previous paragraph are included in All Other and Eliminations.

As discussed in Note 2 to the consolidated financial statements, the Company acquired PlainsCapital and its subsidiaries on November 30, 2012. Prior to this acquisition, the Company operated as a single segment through its insurance subsidiary, NLC, given the integrated monitoring, control and management of its fire and homeowners insurance business lines.

The following presents certain information about reportable segment revenues, operating results, goodwill and assets (in thousands).

| | Banking | Mortgage Origination | Insurance | Financial Advisory | All Other and Eliminations | Hilltop Consolidated |
|---|---|---|---|---|---|---|
| **Three Months Ended September 30, 2013** | | | | | | |
| Net interest income (expense) | $ 70,230 | $ (8,907) | $ 902 | $ 2,682 | $ 6,545 | $ 71,452 |
| Provision for loan losses | 10,661 | | | (3) | | 10,658 |
| Noninterest income | 17,156 | 127,460 | 42,162 | 25,709 | (6,729) | 205,758 |
| Noninterest expense | 34,474 | 115,135 | 38,795 | 28,324 | (111) | 216,617 |
| Income (loss) before income taxes | $ 42,251 | $ 3,418 | $ 4,269 | $ 70 | $ (73) | $ 49,935 |

| | Banking | Mortgage Origination | Insurance | Financial Advisory | All Other and Eliminations | Hilltop Consolidated |
|---|---|---|---|---|---|---|
| **Nine Months Ended September 30, 2013** | | | | | | |
| Net interest income (expense) | $ 206,661 | $ (32,849) | $ 2,755 | $ 9,409 | $ 21,162 | $ 207,138 |
| Provision for loan losses | 34,927 | | | 25 | | 34,952 |
| Noninterest income | 41,041 | 439,246 | 122,365 | 77,349 | (21,732) | 658,269 |
| Noninterest expense | 98,484 | 373,405 | 135,729 | 84,887 | (497) | 692,008 |
| Income (loss) before income taxes | $ 114,291 | $ 32,992 | $ (10,609) | $ 1,846 | $ (73) | $ 138,447 |
| | | | | | | |
| **September 30, 2013** | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Goodwill | $ 207,741 | $ 13,071 | $ 23,988 | $ 7,008 | $ | $ 251,808 |
| Total assets | $ 8,143,611 | $ 1,212,909 | $ 306,308 | $ 530,959 | $ (1,100,195) | $ 9,093,592 |
| **December 31, 2012** | | | | | | |
| Goodwill | $ 209,703 | $ 13,071 | $ 23,988 | $ 7,008 | $ | $ 253,770 |
| Total assets | $ 6,195,775 | $ 1,548,384 | $ 305,699 | $ 592,017 | $ (1,355,010) | $ 7,286,865 |

**21. Earnings (Loss) per Common Share**

Nonvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and are included in the computation of earnings per share pursuant to the two-class method prescribed by the Earnings Per Share Topic of the ASC. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. In May 2013, as discussed in Note 13 to the consolidated financial statements, Hilltop issued Restricted Stock Awards which qualify as participating securities.

Net earnings, less any preferred dividends accumulated for the period (whether or not declared), is allocated between the common stock and participating securities pursuant to the two-class method. Basic earnings per common share is computed by dividing net earnings available to common shareholders by the weighted average number of common shares outstanding during the period, excluding participating nonvested restricted shares.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Diluted earnings per common share is computed in a similar manner, except that first the denominator is increased to include the number of additional common shares that would have been outstanding if potentially dilutive common shares, excluding the participating securities, were issued using the treasury stock method. For all periods presented, stock options are the only potentially dilutive non-participating instruments issued by Hilltop. Next, we determine and include in diluted earnings per common share calculation the more dilutive effect of the participating securities using the treasury stock method or the two-class method. Undistributed losses are not allocated to the nonvested share-based payment awards (the participating securities) under the two-class method as the holders are not contractually obligated to share in the losses of the Company.

The following table presents the computation of basic and diluted earnings (loss) per common share (in thousands, except per share data).

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Basic earnings (loss) per share: | | | | |
| Income (loss) applicable to Hilltop common stockholders | $ 31,831 | $ (4,048) | $ 85,144 | $ (14,414) |
| Less: income applicable to participating shares | (176) | | (472) | |
| Net earnings (loss) available to Hilltop common stockholders | $ 31,655 | $ (4,048) | $ 84,672 | $ (14,414) |
| | | | | |
| Weighted average shares outstanding - basic | 83,493 | 56,363 | 83,490 | 56,408 |
| | | | | |
| Basic earnings (loss) per common share | $ 0.38 | $ (0.07) | $ 1.01 | $ (0.26) |
| | | | | |
| Diluted earnings (loss) per share: | | | | |
| Income (loss) applicable to Hilltop common stockholders | $ 31,831 | $ (4,048) | $ 85,144 | $ (14,414) |
| Add: interest expense on senior exchangeable notes (net of tax) | 1,053 | | 3,158 | |
| Net earnings (loss) available to Hilltop common stockholders | $ 32,884 | $ (4,048) | $ 88,302 | $ (14,414) |
| | | | | |
| Weighted average shares outstanding - basic | 83,493 | 56,363 | 83,490 | 56,408 |
| Effect of potentially dilutive securities | 6,967 | | 6,761 | |
| Weighted average shares outstanding - diluted | 90,460 | 56,363 | 90,251 | 56,408 |
| | | | | |
| Diluted earnings (loss) per common share | $ 0.36 | $ (0.07) | $ 0.98 | $ (0.26) |

For each of the three and nine months ended September 30, 2012, the computation of diluted loss per common share did not include 6,208,000 equivalent shares of senior exchangeable notes as the equivalent exchange rate per share was in excess of the average stock prices for the noted periods. Additionally, options to purchase 700,000 shares of Hilltop s common stock were not included in the computation of diluted loss per common share for each of the three and nine months ended September 30, 2012, as their inclusion would have been anti-dilutive.

**22. Recently Issued Accounting Standards**

**Comprehensive Income (Loss)**

In February 2013, the FASB issued an amendment to the Comprehensive Income Topic to improve the reporting of reclassifications out of comprehensive income (loss). The amendments require entities to present, either parenthetically on the face of the financial statements or in a single footnote, the effect of significant reclassifications out of each component of accumulated other comprehensive income (loss) by the respective line items of net income (loss) affected by the reclassification. The amendment became effective for the Company on January 1, 2013, and its adoption did not have any effect on the Company s consolidated financial statements as the Company had no such reclassifications during the periods presented.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**Offsetting Asset and Liabilities**

In December 2011, the FASB amended the Balance Sheet Topic of the ASC to require enhanced disclosures about the nature and effect or potential effect of an entity s rights of setoff associated with its financial and derivative instruments. In January 2013, the FASB issued an update to the amendments, which narrowed the scope of the financial instruments for which the enhanced disclosures are applicable. The amendments became effective for the Company on January 1, 2013, and its adoption did not have a significant effect on the Company s financial position, results of operations or cash flows. See Note 16 to the consolidated financial statements for the disclosures required by this Topic.

**23. Subsequent Event**

On October 15, 2013, Hilltop entered into a First Supplemental Indenture pursuant to which Hilltop guaranteed the obligations of HTH Operating Partnership LP, a wholly owned subsidiary of Hilltop ( OP ), under that certain Indenture, dated as of August 9, 2005 (the Indenture ). OP previously issued $96.6 million aggregate principal amount of its 7.5% Senior Exchangeable Notes due 2025 (the Notes ) under the Indenture, of which $90.9 million were outstanding as of October 15, 2013, including $6.9 million aggregate principal amount held by Hilltop s insurance company subsidiaries.

On October 15, 2013, OP called for redemption all outstanding Notes on November 14, 2013 (the Redemption Date ). The Notes will be redeemed at a redemption price equal to the principal amount of the Notes, plus accrued and unpaid interest up to, but excluding, the Redemption Date.

At any time prior to the Redemption Date, holders may exchange their Notes into shares of Hilltop common stock at the rate of 73.94998 shares per $1,000 principal amount of the Notes (or approximately $13.52 per share). In lieu of delivery of Hilltop common stock upon the exercise of a holder of its exchange right, OP may elect to pay such holder of the Notes an amount in cash (or a combination of Hilltop common stock and cash) in respect of all or a portion of such holder s Notes equal to the closing price of Hilltop s common stock for the five consecutive trading days commencing on and including the third business day following the exercise of such exchange right. As of November 8, 2013, such redemptions resulted in the issuance of 2,896,316 shares of Hilltop common stock.

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

*The following discussion should be read in conjunction with the consolidated historical financial statements and notes appearing elsewhere in this Quarterly Report on Form 10-Q and the financial information set forth in the tables herein.*

*Unless the context otherwise indicates, in this Quarterly Report on Form 10-Q, references to the Company, we, us, our or ours or similar words are to Hilltop Holdings Inc. and its direct and indirect wholly owned subsidiaries, references to Hilltop refer solely to Hilltop Holdings Inc., references to PlainsCapital refer to PlainsCapital Corporation (a wholly owned subsidiary of Hilltop), references to the Bank refer to PlainsCapital Bank (a wholly owned subsidiary of PlainsCapital), references to FNB refer to First National Bank, references to First Southwest refer to First Southwest Holdings, LLC (a wholly owned subsidiary of the Bank) and its subsidiaries as a whole, references to FSC refer to First Southwest Company (a wholly owned subsidiary of First Southwest), references to PrimeLending refer to PrimeLending, a PlainsCapital Company (a wholly owned subsidiary of the Bank) and its subsidiaries as a whole and references to NLC refer to National Lloyds Corporation, formerly known as NLASCO, Inc., (a wholly owned subsidiary of Hilltop) and its subsidiaries as a whole.*

**FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q and the documents incorporated by reference into this report include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act, as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included in this report that address results or developments that we expect or anticipate will or may occur in the future, and statements that are preceded by, followed by or include, words such as anticipates, believes, could, estimates, expects, forecasts, intends, may, probal seeks, should or would or the negative of these words and phrases or similar words or phrases, including such things as our business strategy, our financial condition, our litigation, our efforts to make strategic acquisitions, our revenue, our liquidity and sources of funding, market trends, operations and business, expectations concerning mortgage loan origination volume, anticipated changes in our revenues or earnings, the effects of government regulation applicable to our operations, the appropriateness of our allowance for loan losses and provision for loan losses, and the collectability of loans are forward-looking statements.

These forward-looking statements are based on our beliefs, assumptions and expectations of our future performance taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If an event occurs, our business, business plan, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Certain factors that could cause actual results to differ include, among others:

- changes in the default rate of our loans and risks associated with concentration in real estate related loans;

- changes in general economic, market and business conditions in areas or markets where we compete;

- changes in the interest rate environment;

- cost and availability of capital;

- changes in state and federal laws, regulations or policies affecting one or more of our business segments, including changes in regulatory fees, deposit insurance premiums, capital requirements and the Dodd-Frank Wall Street Reform and Consumer Protection Act;

- our participation in governmental programs, including the Small Business Lending Fund;

- severe catastrophic events in our geographic area;

- failure of our insurance segment reinsurers to pay obligations under reinsurance contracts;

- changes in key management;

- approval of new, or changes in, accounting policies and practices;

- our ability to estimate loan losses;

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- our ability to use net operating loss carry forwards to reduce future tax payments;

- competition in our banking, mortgage origination, financial advisory and insurance segments from other banks and financial institutions as well as insurance companies, mortgage bankers, investment banking and financial advisory firms, asset-based non-bank lenders and government agencies;

- risks associated with merger and acquisition integration;

- our ability to obtain reimbursements for losses on acquired loans under loss-share agreements with the Federal Deposit Insurance Corporation (the FDIC ); and

- our ability to use excess cash in an effective manner, including the execution of successful acquisitions.

For a more detailed discussion of these and other factors that may affect our business and that could cause the actual results to differ materially from those anticipated in these forward-looking statements, please refer to Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission (the SEC ) on March 15, 2013, and other filings we have made with the SEC. Consequently, all of the forward-looking statements made in this Quarterly Report on Form 10-Q are qualified by these cautionary statements and those risk factors, and actual results or developments anticipated by us may not be realized, or even substantially realized, and they may not have the expected consequences to, or effects on, us and our business or operations. Forward-looking statements made in this report speak as of the date of this report or as of the date specifically referenced in any such statement set forth in this report. Except to the extent required by law, we undertake no obligation to update or revise any forward-looking statements in this report.

**OUR GENERAL CORPORATE STRUCTURE**

We are 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, the Company acquired PlainsCapital Corporation in a stock and cash transaction, whereby 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 (the PlainsCapital Merger ). 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 ( Hilltop Series B Preferred Stock ). 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.

Prior to the consummation of the PlainsCapital Merger, our 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 our wholly owned property and casualty insurance holding company, NLC. NLC operates through its wholly owned subsidiaries, National Lloyds Insurance Company

( NLIC ) and American Summit Insurance Company ( ASIC ).

On September 13, 2013 (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, as receiver, and reopened acquired branches of FNB 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. Based on preliminary purchase date valuations, the fair market value of the assets acquired was $2.2 billion, including $1.1 billion in covered loans, $286.2 million in securities, $121.0 million in covered OREO and $45.9 million in non-covered loans. The Bank also assumed $2.2 billion in liabilities, consisting primarily of deposits.

Following the PlainsCapital Merger on November 30, 2012, our primary line of business has been to provide business and consumer banking services from offices located throughout central, north and west Texas through the Bank. The Bank s subsidiaries have specialized areas of expertise that allow us to provide an array of financial products and services such as mortgage origination and financial advisory services. The acquisition of FNB s expansive branch network allows the Bank to further develop its Texas footprint through expansion into the Rio Grande Valley, Houston, Corpus Christi, Laredo and El Paso markets, among others.

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**OVERVIEW**

As a result of the PlainsCapital Merger, the operating results of the Company beginning December 1, 2012 include the banking, mortgage origination and financial advisory operations acquired in the PlainsCapital Merger. Accordingly, our operating results and financial condition for the three and nine months ended September 30, 2013 are not comparable to prior periods. Additionally, the presentation of the Company s historical consolidated financial statements has been modified and certain items have been reclassified to conform to current period presentation, which is more consistent with that of a financial institution that provides an array of financial products and services.

The operations of FNB are included in the Company s operating results beginning September 14, 2013, and were not significant to the Company s consolidated statements of operations for the three and nine months ended September 30, 2013. FNB s results of operations prior to the Bank Closing Date are not included in the Company s consolidated operating results.

***How We Generate Revenue***

We generate revenue from net interest income and from noninterest income. Net interest income represents the difference between the income earned on our assets, including our loans and investment securities, and our cost of funds, including the interest paid on the deposits and borrowings that are used to support our assets. Net interest income is a significant contributor to our operating results. Fluctuations in interest rates, as well as the amounts and types of interest-earning assets and interest-bearing liabilities we hold, affect net interest income. We generated $207.1 million in net interest income during the nine months ended September 30, 2013, compared with net interest income of $3.7 million during the nine months ended September 30, 2012. The significant increase in net interest income during 2013 was primarily due to $204.6 million in net interest income during the nine months ended September 30, 2013 generated by those operations acquired as part of the PlainsCapital Merger.

The other component of our revenue is noninterest income, which is primarily comprised of the following:

(i) *Income from mortgage operations*. Through our wholly owned subsidiary, PrimeLending, we generate noninterest income by originating and selling mortgage loans. During the nine months ended September 30, 2013, we generated $439.1 million in net gains from the sale of loans, other mortgage production income, and mortgage loan origination fees.

(ii) *Net insurance premiums earned.* Through our wholly owned insurance subsidiary, NLC, we provide fire and limited homeowners insurance for low value dwellings and manufactured homes. We generated $116.0 million in net insurance premiums earned during the nine months ended September 30, 2013, compared with $109.0 million during the same period in the prior year.

(iii) *Investment advisory fees and commissions and securities brokerage fees and commissions.* Through our wholly owned subsidiary, First Southwest, we provide public finance advisory and various investment banking and brokerage services. We generated $70.3 million in investment advisory fees and commissions and securities brokerage fees and commissions during the nine months ended

September 30, 2013.

In the aggregate, we generated $658.3 million in noninterest income during the nine months ended September 30, 2013, compared with $114.5 million during the same period in the prior year. The significant increase in noninterest income during 2013 was primarily due to the inclusion of the mortgage origination and financial advisory operations that we acquired as a part of the PlainsCapital Merger.

We also incur noninterest expenses in the operation of our businesses. Our businesses engage in labor intensive activities and, consequently, employees compensation and benefits represent the majority of our noninterest expenses.

***Segment Information***

As a result of the PlainsCapital Merger, we have two primary operating business units, PlainsCapital (financial services and products) and NLC (insurance). Within the PlainsCapital unit are three primary wholly owned subsidiaries: the Bank, PrimeLending and First Southwest. Under accounting principles generally accepted in the United States ( GAAP ), our business units are comprised of four reportable business segments that are organized primarily by the core products offered to the segments respective customers: banking, mortgage origination, insurance and financial advisory. We anticipate that

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future revenues will be driven primarily from the banking and mortgage origination segments, with the remainder being generated by our insurance and financial advisory segments. Based on historical results of PlainsCapital Corporation, the relative share of total revenue provided by our banking and mortgage origination segments fluctuates depending on market conditions, and operating results for the mortgage origination segment tend to be more volatile than operating results for the banking segment.

The banking segment includes the operations of the Bank, which, since September 14, 2013, includes the operations acquired in the FNB Transaction. The banking segment primarily provides business and consumer banking products and services from offices located throughout Texas and generates revenue from its portfolio of earning assets. The Bank s results of operations are primarily dependent on net interest income, while also deriving revenue from other sources, including service charges on customer deposit accounts and trust fees.

The mortgage origination segment includes the operations of PrimeLending, which offers a variety of loan products from offices in 42 states and generates revenue predominantly from fees charged on the origination of loans and from selling these loans in the secondary market.

The insurance segment includes the operations of NLC, which operates through its wholly owned subsidiaries, NLIC and ASIC. Insurance segment income is primarily generated from revenue earned on net insurance premiums less loss and loss adjustment expenses ( LAE ) and policy acquisition and other underwriting expenses in Texas and other areas of the southern United States.

The financial advisory segment generates a majority of its revenues from fees and commissions earned from investment advisory and securities brokerage services at First Southwest. The principal subsidiaries of First Southwest are FSC, a broker-dealer registered with the SEC and Financial Industry Regulatory Authority, and First Southwest Asset Management, Inc., a registered investment advisor under the Investment Advisors Act of 1940. FSC holds trading securities to support sales, underwriting and other customer activities. These securities are marked to market through other noninterest income. FSC uses derivatives to support mortgage origination programs of certain non-profit housing organization clients. FSC hedges its related exposure to interest rate risk from these programs with U.S. Agency to-be-announced, or TBA, mortgage-backed securities. These derivatives are marked to market through other noninterest income.

Additional information concerning our reportable segments is presented in Note 20, Segment and Related Information, in the notes to our consolidated financial statements. The following tables present certain information about the operating results of our reportable segments (in thousands).

| Three Months Ended September 30, 2013 | Banking | Mortgage Origination | Insurance | Financial Advisory | All Other and Eliminations | Hilltop Consolidated |
|---|---|---|---|---|---|---|
| Net interest income (expense) | $ 70,230 | $ (8,907) | $ 902 | $ 2,682 | $ 6,545 | $ 71,452 |
| Provision for loan losses | 10,661 | | | (3) | | 10,658 |
| Noninterest income | 17,156 | 127,460 | 42,162 | 25,709 | (6,729) | 205,758 |
| Noninterest expense | 34,474 | 115,135 | 38,795 | 28,324 | (111) | 216,617 |
| Income before income taxes | $ 42,251 | $ 3,418 | $ 4,269 | $ 70 | $ (73) | $ 49,935 |

| Nine Months Ended September 30, 2013 | Banking | Mortgage Origination | Insurance | Financial Advisory | All Other and Eliminations | Hilltop Consolidated |
|---|---|---|---|---|---|---|
| Net interest income (expense) | $ 206,661 | $ (32,849) | $ 2,755 | $ 9,409 | $ 21,162 | $ 207,138 |
| Provision for loan losses | 34,927 | | | 25 | | 34,952 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Noninterest income | 41,041 | 439,246 | 122,365 | 77,349 | (21,732) | 658,269 |
| Noninterest expense | 98,484 | 373,405 | 135,729 | 84,887 | (497) | 692,008 |
| Income before income taxes | $ 114,291 | $ 32,992 | $ (10,609) | $ 1,846 | $ (73) | $ 138,447 |

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***Operating Results***

The net income applicable to common stockholders for the three months ended September 30, 2013 was $31.8 million, or $0.36 per diluted share, compared to net loss applicable to common stockholders of $4.0 million, or $0.07 per diluted share, for the three months ended September 30, 2012. The net income applicable to common stockholders for the nine months ended September 30, 2013 was $85.1 million, or $0.98 per diluted share, compared to net loss applicable to common stockholders of $14.4 million, or $0.26 per diluted share, for the nine months ended September 30, 2012.

As a result of the PlainsCapital Merger on November 30, 2012, the net income of PlainsCapital is included in the operating results of the Company for the three and nine months ended September 30, 2013. The operations acquired in the FNB Transaction are included in the Company s operating results beginning September 14, 2013, and were therefore not fully reflected in the Company s consolidated statement of operations for the three months ended September 30, 2013. FNB s results of operations prior to the Bank Closing Date are not included in the Company s consolidated operating results. However, we expect the operations acquired in the FNB Transaction to have a significant effect on the Bank s operating results beginning in the fourth quarter of 2013.

Certain items included in net income for 2013 resulted from purchase accounting associated with the PlainsCapital Merger and FNB Transaction. During the three months ended September 30, 2013, the pre-tax effects of these items include net accretion on acquired earning assets and liabilities of $15.2 million, offset by amortization of identifiable intangibles of $2.5 million. PlainsCapital also recorded provisions for loan losses related to acquired performing loans of approximately $2.6 million for the three months ended September 30, 2013. The aggregate after tax impact of these items was to increase net income by $6.4 million for the three months ended September 30, 2013. During the nine months ended September 30, 2013, the pre-tax effects of these items include net accretion on acquired earning assets and liabilities of $47.1 million, offset by amortization of identifiable intangibles of $7.4 million. PlainsCapital also recorded provisions for loan losses related to acquired performing loans of approximately $14.9 million for the nine months ended September 30, 2013. The aggregate after tax impact of these items was to increase net income by $15.5 million for the nine months ended September 30, 2013.

We consider the ratios shown in the table below to be key indicators of our performance.

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|---|---|
| **Performance Ratios (1):** | | |
| Return on average stockholders equity | 10.92% | 9.95% |
| Return on average assets | 1.73% | 1.63% |
| Net interest margin (taxable equivalent) (2) | 4.45% | 4.38% |

(1) Noted measures are typically used for measuring the performance of banking and financial institutions. Our operations prior to the acquisition of PlainsCapital are limited to our insurance operations. Therefore, noted measures for periods prior to 2013 are not useful measures and have been excluded.

(2) Annualized taxable equivalent net interest income divided by average interest-earning assets.

During the three months ended September 30, 2013, the consolidated taxable equivalent net interest margin of 4.45% was impacted by accretion of discount on loans of $15.7 million, amortization of premium on acquired securities of $1.2 million and amortization of premium on acquired time deposits of $0.8 million. The consolidated taxable equivalent net interest margin for the nine months ended September 30, 2013 of 4.38% was impacted by accretion of discount on loans of $49.3 million, amortization of premium on acquired securities of $4.6 million and amortization of premium on acquired time deposits of $2.4 million. As a result of these items, the consolidated taxable equivalent net interest margin increased by 92 basis points and 95 basis points during the three and nine months ended September 30, 2013, respectively.

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The table below provides additional details regarding our consolidated net interest income for the three and nine months ended September 30, 2013 (dollars in thousands).

| | Three Months Ended September 30, 2013 | | | Nine Months Ended September 30, 2013 | | |
|---|---|---|---|---|---|---|
| | Average Outstanding Balance | Interest Earned or Paid | Annualized Yield or Rate | Average Outstanding Balance | Interest Earned or Paid | Annualized Yield or Rate |
| **Assets** | | | | | | |
| Interest-earning assets | | | | | | |
| Loans, gross (1) | $ 4,451,589 | $ 68,121 | 6.03% | $ 4,338,209 | $ 198,220 | 6.04% |
| Investment securities - taxable | 976,775 | 7,202 | 2.97% | 958,220 | 19,594 | 2.76% |
| Investment securities - non-taxable (2) | 166,789 | 1,641 | 3.93% | 195,316 | 5,383 | 4.29% |
| Federal funds sold and securities purchased under agreements to resell | 36,762 | 35 | 0.38% | 27,281 | 91 | 0.45% |
| Interest-bearing deposits in other financial institutions | 591,581 | 282 | 0.19% | 636,203 | 857 | 0.18% |
| Other | 166,559 | 2,546 | 5.66% | 162,001 | 7,660 | 5.86% |
| Interest-earning assets, gross | 6,390,055 | 79,827 | 4.93% | 6,317,230 | 231,805 | 4.88% |
| Allowance for non-covered loan losses | (29,042) | | | (18,884) | | |
| Interest-earning assets, net | 6,361,013 | | | 6,298,346 | | |
| Noninterest-earning assets | 985,793 | | | 905,077 | | |
| **Total assets** | $ 7,346,806 | | | $ 7,203,423 | | |
| | | | | | | |
| **Liabilities and Stockholders Equity** | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits | $ 4,877,836 | $ 3,685 | 0.30% | $ 4,621,094 | $ 10,541 | 0.30% |
| Notes payable and other borrowings | 696,472 | 4,101 | 2.02% | 773,656 | 12,331 | 1.82% |
| Total interest-bearing liabilities | 5,574,308 | 7,786 | 0.54% | 5,394,750 | 22,872 | 0.55% |
| Noninterest-bearing liabilities | | | | | | |
| Noninterest-bearing deposits | 159,244 | | | 160,836 | | |
| Other liabilities | 431,529 | | | 472,648 | | |
| Total liabilities | 6,165,081 | | | 6,028,234 | | |
| Stockholders equity | 1,181,165 | | | 1,174,512 | | |
| Noncontrolling interest | 560 | | | 677 | | |
| **Total liabilities and stockholders equity** | $ 7,346,806 | | | $ 7,203,423 | | |
| | | | | | | |
| **Net interest income (2)** | | $ 72,041 | | | $ 208,933 | |
| **Net interest spread (2)** | | | 4.39% | | | 4.33% |
| **Net interest margin (2)** | | | 4.45% | | | 4.38% |

(1) Average balance includes non-accrual loans.

(2) Annualized taxable equivalent adjustments are based on a 35% tax rate. The adjustment to interest income was $0.6 million and $1.8 million for the three and nine months ended September 30, 2013, respectively.

On a consolidated basis, net interest income increased $70.2 million and $203.4 million for the three and nine months ended September 30, 2013, respectively, compared with the same periods in 2012. These increases were primarily due to the inclusion of the results of operations of the banking segment, which was acquired in the PlainsCapital Merger on November 30, 2012. Net interest income during the three and nine months ended September 30, 2012 was limited to interest income on securities and interest expense on notes payable of the insurance segment.

The provision for loan losses is determined by management as the amount to be added to the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management s best estimate, is necessary to absorb probable losses within the existing loan portfolio. The consolidated provision for loan losses, primarily in the banking segment, was $10.7 million for the three months ended September 30, 2013 and $35.0 million for the nine months ended September 30, 2013. During the three and nine months ended September 30, 2013, the provision for loan losses was comprised of charges relating to newly originated loans and acquired performing loans of approximately $8.4 million and $32.0 million, respectively, and purchased credit impaired ( PCI ) loans of approximately $2.3 million and $3.0 million, respectively.

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Consolidated noninterest income increased $166.2 million and $543.8 million during the three and nine months ended September 30, 2013, respectively, compared with the same periods in 2012. The increases in 2013 were primarily due to the inclusion of $153.2 million and $516.6 million during the three and nine months ended September 30, 2013, respectively, of noninterest income generated from the operations of the mortgage origination and financial advisory segments, which were acquired in the PlainsCapital Merger. Consolidated noninterest income during the three and nine months ended September 30, 2013 also included increases in net insurance premiums earned of $2.3 million and $7.0 million, respectively, compared with the same periods in 2012. In addition, the FNB Transaction resulted in the recognition of a pre-tax bargain purchase gain of $3.3 million, which is considered preliminary because management made significant estimates and exercised significant judgment in estimating fair values and accounting for the FNB Transaction due to the short time period between the Bank Closing Date and September 30, 2013.

Our consolidated noninterest expense during the three and nine months ended September 30, 2013 increased $169.8 million and $552.4 million, respectively, compared with the same periods in 2012. The increases primarily resulted from the inclusion of $177.9 million and $556.8 million during the three and nine months ended September 30, 2013, respectively, in employees compensation and benefits, occupancy and equipment and other expenses specifically attributable to those segments acquired as a part of the PlainsCapital Merger. The balance of increases in our consolidated noninterest expenses during the three and nine months ended September 30, 2013 were primarily related to loss and LAE and policy acquisition and other underwriting expenses specific to our insurance segment.

Consolidated income tax expense for the three and nine months ended September 30, 2013 was $16.6 million and $49.1 million, respectively, reflecting effective rates of 33.3% and 35.5%, respectively. During the three and nine months ended September 30, 2012, we recorded an income tax benefit, due to losses from operations, of $1.9 million and $7.0 million, respectively, reflecting an effective rate of 32.1% and 32.5%, respectively. The increase in income tax expense during 2013 was due to the operating income generated by PlainsCapital.

***Segment Results***

**Banking Segment**

Income before income taxes for the three and nine months ended September 30, 2013 was $42.3 million and $114.3 million, respectively, and was primarily driven by net interest income of $70.2 million and $206.7 million, respectively, partially offset by noninterest expenses of $34.5 million and $98.5 million, respectively, during the three and nine months ended September 30, 2013.

At September 30, 2013, the Bank exceeded all regulatory capital requirements with a total capital to risk weighted assets ratio of 13.36%, Tier 1 capital to risk weighted assets ratio of 12.76% and a Tier 1 capital to average assets, or leverage, ratio of 11.05%. At September 30, 2013, the Bank was also considered to be well-capitalized under regulatory requirements without giving effect to the final Basel III capital rules adopted by the Federal Reserve Board on July 2, 2013.

We consider the ratios shown in the table below to be key indicators of the performance of our banking segment.

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|---|---|
| **Performance Ratios (1):** | | |
| Efficiency ratio (2) | 41.04% | 40.32% |
| Return on average assets | 1.81% | 1.68% |
| Net interest margin (taxable equivalent) (3) | 5.07% | 5.16% |

(1) The banking segment was acquired in December 2012. Therefore, noted measures for periods prior to 2013 are not useful measures and have been excluded.

(2) Noninterest expenses divided by the sum of total noninterest income and net interest income for the period.

(3) Annualized taxable equivalent net interest income divided by average interest-earning assets.

During the three months ended September 30, 2013, the taxable equivalent net interest margin of 5.07% was impacted by accretion of discount on loans of $15.7 million, amortization of premium on acquired securities of $1.2 million and amortization of premium on acquired time deposits of $0.8 million. The taxable equivalent net interest margin for the nine

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months ended September 30, 2013 of 5.16% was impacted by accretion of discount on loans of $49.3 million, amortization of premium on acquired securities of $4.6 million and amortization of premium on acquired time deposits of $2.4 million. As a result of these items, the taxable equivalent net interest margin increased by 105 basis points and 112 basis points during the three and nine months ended September 30, 2013, respectively.

The table below provides additional details regarding our banking segment s net interest income for the three and nine months ended September 30, 2013 (dollars in thousands).

| | Three Months Ended September 30, 2013 | | | Nine Months Ended September 30, 2013 | | |
|---|---|---|---|---|---|---|
| | Average Outstanding Balance | Interest Earned or Paid | Annualized Yield or Rate | Average Outstanding Balance | Interest Earned or Paid | Annualized Yield or Rate |
| **Assets** | | | | | | |
| Interest-earning assets | | | | | | |
| Loans, gross (1) | $ 3,135,680 | $ 55,918 | 7.00% | $ 2,995,848 | $ 163,162 | 7.20% |
| Subsidiary warehouse lines of credit | 970,323 | 12,907 | 5.20% | 984,857 | 41,122 | 5.51% |
| Investment securities - taxable | 789,451 | 4,088 | 2.07% | 758,330 | 10,267 | 1.81% |
| Investment securities - non-taxable (2) | 154,518 | 1,430 | 3.70% | 159,671 | 4,242 | 4.15% |
| Federal funds sold and securities purchased under agreements to resell | 35,127 | 25 | 0.29% | 25,111 | 53 | 0.28% |
| Interest-bearing deposits in other financial institutions | 371,196 | 282 | 0.30% | 389,383 | 806 | 0.28% |
| Other | 41,798 | 385 | 3.68% | 34,818 | 935 | 3.58% |
| Interest-earning assets, gross | 5,498,093 | 75,035 | 5.36% | 5,348,018 | 220,587 | 5.47% |
| Allowance for non-covered loan losses | (28,885) | | | (18,730) | | |
| Interest-earning assets, net | 5,469,208 | | | 5,329,288 | | |
| Noninterest-earning assets | 913,615 | | | 840,050 | | |
| **Total assets** | $ 6,382,823 | | | $ 6,169,338 | | |
| | | | | | | |
| **Liabilities and Stockholders Equity** | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits | $ 4,874,003 | $ 3,711 | 0.30% | $ 4,591,551 | $ 10,528 | 0.31% |
| Notes payable and other borrowings | 384,843 | 324 | 0.33% | 429,727 | 1,053 | 0.33% |
| Total interest-bearing liabilities (3) | 5,258,846 | 4,035 | 0.30% | 5,021,278 | 11,581 | 0.31% |
| Noninterest-bearing liabilities | | | | | | |
| Noninterest-bearing deposits | 214,476 | | | 231,849 | | |
| Other liabilities | 22,903 | | | 46,597 | | |
| Total liabilities | 5,496,225 | | | 5,299,724 | | |
| Stockholders equity | 886,598 | | | 869,614 | | |
| **Total liabilities and stockholders equity** | $ 6,382,823 | | | $ 6,169,338 | | |
| | | | | | | |
| **Net interest income (2)** | | $ 71,000 | | | $ 209,006 | |
| **Net interest spread (2)** | | | 5.06% | | | 5.16% |

| | | |
|---|---|---|
| **Net interest margin (2)** | 5.07% | 5.16% |

(1) Average balance includes non-accrual loans.

(2) Annualized taxable equivalent adjustments are based on a 35% tax rate. The adjustment to interest income was $0.5 million and $1.5 million for the three and nine months ended September 30, 2013, respectively.

(3) Excludes the allocation of interest income of $0.6 million and $1.8 million and interest expense on Hilltop debt of $0.9 million and $2.7 million for the three and nine months ended September 30, 2013, respectively.

The banking segment s net interest margin shown above exceeds our consolidated net interest margin. Our consolidated net interest margin includes the yields and costs associated with certain items within interest-earning assets and interest-bearing liabilities in the financial advisory segment, as well as the borrowing costs of Hilltop and PlainsCapital, both of which reduce our consolidated net interest margin. In addition, the banking segment s interest earning assets include lines of credit extended to subsidiaries, the yields on which increase the banking segment s net interest margin. Such yields and costs are eliminated from the consolidated financial statements.

The banking segment s noninterest expenses were $34.5 million and $98.5 million during the three and nine months ended September 30, 2013, respectively, and were primarily comprised of employees compensation and benefits, and occupancy expenses.

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**Mortgage Origination Segment**

Income before income taxes for the three and nine months ended September 30, 2013 was $3.4 million and $33.0 million, respectively. Income before income taxes was primarily driven by noninterest income of $127.5 million and $439.2 million, respectively, partially offset by noninterest expense of $115.1 million and $373.4 million, respectively, during the three and nine months ended September 30, 2013. Additionally, net interest expense of $8.9 million and $32.8 million during the three and nine months ended September 30, 2013, respectively, resulted from interest expense on a warehouse line of credit held at the Bank as well as related intercompany financing costs, partially offset by interest income earned on loans held for sale.

PrimeLending originates all of its mortgage loans through a retail channel. The following table provides certain details regarding our mortgage loan originations (dollars in thousands).

| | Three Months Ended September 30, 2013 | % of Total | Nine Months Ended September 30, 2013 | % of Total |
|---|---|---|---|---|
| Mortgage Loan Originations - units | 13,727 | | 44,681 | |
| | | | | |
| Mortgage Loan Originations - volume | $ 2,851,627 | | $ 9,447,550 | |
| | | | | |
| Mortgage Loan Originations: | | | | |
| Conventional | $ 1,841,025 | 64.56% | $ 6,017,174 | 63.69% |
| Government | 856,127 | 30.02% | 2,801,915 | 29.66% |
| Jumbo | 144,027 | 5.05% | 596,478 | 6.31% |
| Other | 10,448 | 0.37% | 31,993 | 0.34% |
| | $ 2,851,627 | 100.00% | $ 9,447,560 | 100.00% |
| | | | | |
| Home purchases | $ 2,342,508 | 82.15% | $ 6,330,240 | 67.00% |
| Refinancings | 509,119 | 17.85% | 3,117,320 | 33.00% |
| | $ 2,851,627 | 100.00% | $ 9,447,560 | 100.00% |
| | | | | |
| Texas | $ 665,504 | 23.34% | $ 2,111,761 | 22.35% |
| California | 457,812 | 16.05% | 1,683,019 | 17.81% |
| North Carolina | 138,446 | 4.86% | 494,652 | 5.24% |
| Virginia | 107,860 | 3.78% | 389,374 | 4.12% |
| Florida | 117,891 | 4.13% | 344,483 | 3.65% |
| Maryland | 86,326 | 3.03% | 320,142 | 3.39% |
| Arizona | 87,739 | 3.08% | 318,473 | 3.37% |
| All other states | 1,190,049 | 41.73% | 3,785,656 | 40.07% |
| | $ 2,851,627 | 100.00% | $ 9,447,560 | 100.00% |

The mortgage lending business is subject to variables that can impact loan origination volume, including seasonal and interest rate fluctuations. Historically, we have typically experienced increased loan origination volume from purchases of homes during the spring and summer, when more people tend to move and buy or sell homes. An increase in mortgage interest rates tends to result in decreased loan origination volume from refinancings, while a decrease in rates tends to result in increased refinancings. Changes in interest rates have historically had a lesser impact on home purchases volume than on refinancing volume.

Beginning in May 2013 and continuing through September 2013, mortgage interest rates increased at a pace that resulted in decreasing the mortgage origination segment s total loan origination volume during the third quarter of 2013 by approximately 20% when compared to the prior quarter. Home purchases volume of $2.3 billion during the three months ended September 30, 2013 was virtually unchanged from the three months ended June 30, 2013, while refinancing volume decreased from $1.2 billion (33% of total loan origination volume) to $0.5 billion (18% of total loan origination volume) between the same periods. While mortgage interest rates trended downward during the latter part of September, rates at September 30, 2013 approximated those at June 30, 2013. Due to the recent volatility in mortgage interest rates and uncertain consumer confidence, mortgage loan origination volume for the remainder of 2013 may vary from origination trends historically experienced by the mortgage origination segment.

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While PrimeLending s total loan origination volume decreased approximately 20% during the third quarter of 2013 compared to the prior quarter, income before income taxes decreased approximately 81%. Income before income taxes decreased at a greater rate primarily because segment operating costs included in noninterest expenses, including salaries, occupancy, and administrative expenses, were relatively unchanged between the two periods. To address negative trends in loan origination volume resulting from recent changes in interest rates, the mortgage origination segment reduced its non-origination employee headcount by approximately 10% during the third quarter of 2013. Third quarter expenses were not significantly impacted by the headcount reductions, since decreases in employees compensation and benefits resulting from the reductions were mostly offset by related severance expense. We anticipate that we will begin to realize the benefits of these reductions during the fourth quarter of 2013. We also made additional headcount reductions that were initiated in the fourth quarter of 2013 and are engaging in other initiatives to reduce operating costs. We expect to begin realizing the benefits of these measures during the fourth quarter of 2013.

Noninterest income of $127.5 million and $439.2 million for the three and nine months ended September 30, 2013, respectively, was comprised of net gains on the sale of loans and other mortgage production income, and mortgage origination fees. Noninterest income for the three months ended September 30, 2013 included $14.5 million of net losses resulting from changes in the fair value of the mortgage origination segment s interest rate lock commitments ( IRLCs ) and loans held for sale, and the related activity associated with forward commitments used by PrimeLending to mitigate interest rate risk associated with its IRLCs and mortgage loans held for sale. The loss was primarily the result of a decrease in the volume of IRLCs and mortgage loans held for sale between June 30 and September 30, 2013.

Noninterest expenses were $115.1 million and $373.4 million for the three and nine months ended September 30, 2013, respectively. Employees compensation and benefits accounted for the majority of the costs incurred. Compensation that varies with the volume of mortgage loan originations and overall segment profitability comprised approximately 58% and 61% of the total employees compensation and benefits expenses during the three and nine months ended September 30, 2013, respectively. Unreimbursed closing costs during the three and nine months ended September 30, 2013 were $4.4 million and $24.7 million, respectively. PrimeLending records unreimbursed closing costs when it pays a customer s closing costs in return for the customer choosing to accept a higher interest rate on the customer s mortgage loan.

Between January 1, 2005, and September 30, 2013, the mortgage origination segment sold mortgage loans totaling $53.2 billion. These loans were sold under sales contracts that generally include provisions which hold the mortgage origination segment responsible for errors or omissions relating to its representations and warranties that loans sold meet certain requirements, including representations as to underwriting standards and the validity of certain borrower representations in connection with the loan. In addition, the sales contracts typically require the refund of purchased servicing rights plus certain investor servicing costs if a loan experiences an early payment default. While the mortgage origination segment sold loans prior to 2005, it has not experienced, nor does it anticipate experiencing, significant losses on loans originated prior to 2005 as a result of investor claims under these provisions of its sales contracts.

When an investor claim for indemnification of a loan sold is made, we evaluate the claim and determine if the claim can be satisfied through additional documentation or other deliverables. If the claim cannot be satisfied in that matter, we negotiate with the investor to reach a settlement of the claim. Settlements typically result in either the repurchase of a loan or reimbursement to the investor for losses incurred on the loan. Following is a summary of the mortgage origination segments claims resolution activity relating to loans sold between January 1, 2005, and September 30, 2013 (dollars in thousands).

| | Original Loan Balance | | Loss Recognized | |
|---|---|---|---|---|
| | Amount | % of Loans Sold | Amount | % of Loans Sold |
| Claims resolved with no payment | $ 127,287 | 0.24% | $ | 0.00% |

| | | | | |
|---|---|---|---|---|
| Claims resolved as a result of a loan repurchase or payment to an investor for losses incurred (1) | 165,497 | 0.31% | 21,114 | 0.04% |
| | $ 292,784 | 0.55% | $ 21,114 | 0.04% |

(1) Losses incurred include refunded purchased servicing rights.

At September 30, 2013, and December 31, 2012, the mortgage origination segment s indemnification liability reserve totaled $21.0 million and $19.0 million, respectively. The related provision for indemnification losses was $0.9 million and $2.8 million for the three and nine months ended September 30, 2013, respectively.

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**Insurance Segment**

Income before income taxes was $4.3 million during the three months ended September 30, 2013, compared with a loss before income taxes of $6.0 million during the same period in 2012. Losses before income taxes were $10.6 million and $21.4 million during the nine months ended September 30, 2013 and 2012, respectively. The insurance segment is subject to claims arising out of severe weather, the incidence and severity of which are inherently unpredictable. Generally, the insurance segment s insured risks exhibit higher losses in the second and third calendar quarters due to a seasonal concentration of weather-related events in its primary geographic markets. Although weather-related losses (including hail, high winds, tornadoes and hurricanes) can occur in any calendar quarter, the second calendar quarter, historically, has experienced the highest frequency of losses associated with these events. Hurricanes, however, are more likely to occur in the third calendar quarter of the year.

The loss during the nine months ended September 30, 2013 was primarily driven by the severity of three tornado, wind and hail storms during the second quarter of 2013. Based on estimates of the ultimate cost, two of these storms are now considered catastrophic losses as they exceeded our $8 million reinsurance retention during the three months ended September 30, 2013. The estimate of ultimate losses from these storms totaled $26.5 million at September 30, 2013 with a net effect, after reinsurance, of $21.9 million, resulting in a net cost of $1.0 million for the three months ended September 30, 2013. These net costs compare favorably to the same period in the prior year given our improved containment of expected losses from the weather events in May 2013 at June 30, 2013 compared to prior year activity. This year-over-year improvement contributed to combined ratios of 94.0% and 113.7% for the three and nine months ended September 30, 2013, respectively, compared with 114.2% and 118.6% for the three and nine months ended September 30, 2012, respectively. The combined ratio is a measure of overall insurance underwriting profitability, and represents the sum of the loss and LAE ratio and the underwriting expense ratio, which are discussed in more detail below.

Noninterest income of $42.2 million during the three months ended September 30, 2013 included net insurance premiums earned of $40.0 million, compared to $37.7 million for the same period in 2012, while noninterest income of $122.4 million during the nine months ended September 30, 2013 included net insurance premiums earned of $116.0 million, compared to $109.0 million for the same period in 2012. The increase in earned premiums during both periods is primarily attributable to volume and, to a lesser extent, rate increases in homeowners and mobile home products.

Direct insurance premiums written by major product line are presented in the table below (in thousands).

| | Three Months Ended September 30, | | Variance | Nine Months Ended September 30, | | Variance |
|---|---|---|---|---|---|---|
| | 2013 | 2012 | 2013 vs 2012 | 2013 | 2012 | 2013 vs 2012 |
| **Direct Insurance Premiums Written:** | | | | | | |
| Homeowners | $ 21,110 | $ 19,128 | $ 1,982 | $ 61,634 | $ 57,118 | $ 4,516 |
| Fire | 14,086 | 12,712 | 1,374 | 42,097 | 39,809 | 2,288 |
| Mobile Home | 8,098 | 6,779 | 1,319 | 26,827 | 22,996 | 3,831 |
| Commercial | 1,094 | 2,160 | (1,066) | 3,492 | 6,619 | (3,127) |
| Other | 96 | 120 | (24) | 242 | 291 | (49) |
| | $ 44,484 | $ 40,899 | $ 3,585 | $ 134,292 | $ 126,833 | $ 7,459 |

Total direct insurance premiums written increased for the three and nine months ended September 30, 2013 compared to the same periods in 2012 by $4.7 million and $10.6 million, respectively, for our three largest insurance product lines due to growth in our core insurance products. These decreases were partially offset by decreases of $1.1 million and $3.1 million related to a commercial product line that was non-renewed.

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Net insurance premiums earned by major product line are presented in the table below (in thousands).

| | Three Months Ended September 30, 2013 | 2012 | Variance 2013 vs 2012 | Nine Months Ended September 30, 2013 | 2012 | Variance 2013 vs 2012 |
|---|---|---|---|---|---|---|
| **Net Insurance Premiums Earned:** | | | | | | |
| Homeowners | $ 18,937 | $ 17,561 | $ 1,376 | $ 53,259 | $ 49,104 | $ 4,155 |
| Fire | 12,653 | 11,725 | 928 | 36,377 | 34,223 | 2,154 |
| Mobile Home | 7,320 | 6,305 | 1,015 | 23,182 | 19,770 | 3,412 |
| Commercial | 987 | 1,988 | (1,001) | 3,018 | 5,690 | (2,672) |
| Other | 85 | 109 | (24) | 209 | 251 | (42) |
| | $ 39,982 | $ 37,688 | $ 2,294 | $ 116,045 | $ 109,038 | $ 7,007 |

Net insurance premiums earned for the three and nine months ended September 30, 2013 increased as compared to the same period in 2012, primarily due to increases in net insurance premiums written of $3.9 million and $8.6 million, respectively. These increases were offset by an increase in unearned insurance premiums of $1.6 million during the three and nine months ended September 30, 2013 as compared to the same periods in 2012.

Noninterest expenses of $38.8 million and $135.7 million during the three and nine months ended September 30, 2013, respectively, include both loss and LAE expenses and policy acquisition and other underwriting expenses, as well as other noninterest expenses. Loss and LAE for the three months ended September 30, 2013 was $24.6 million, as compared to $30.1 million for the same period in 2012, resulting in loss and LAE ratios of 61.6% and 80.0% for the three months ended September 30, 2013 and 2012, respectively. Loss and LAE for the nine months ended September 30, 2013 was $94.0 million, as compared to $91.7 million for the same period in 2012. As a result, the loss and LAE ratio for the nine months ended September 30, 2013 and 2012 was 81.0% and 84.1%, respectively. These year-over-year ratio improvements were primarily a result of growth of earned premium and the improved containment of expected losses from the respective year prior quarter weather events as previously discussed.

Policy acquisition and other underwriting expenses encompass all expenses incurred relative to NLC operations, and include elements of multiple categories of expense otherwise reported as noninterest expense in the consolidated statements of operations. Included in other underwriting expenses during the nine months ended September 30, 2012 is a $1.7 million write down of a policy administration system NLC was unable to successfully implement. Excluding this prior year write down, the expense ratio for the nine months ended September 30, 2012 would have improved to 32.9%, compared to 32.7% for the same period in 2013.

Policy acquisition and other underwriting expenses were as follows (dollars in thousands).

| | Three Months Ended September 30, 2013 | 2012 | Variance 2013 vs 2012 | Nine Months Ended September 30, 2013 | 2012 | Variance 2013 vs 2012 |
|---|---|---|---|---|---|---|
| Amortization of deferred policy acquisition costs | $ 10,418 | $ 9,675 | $ 743 | $ 30,305 | $ 28,821 | $ 1,484 |
| Other underwriting expenses | 3,207 | 3,766 | (559) | 9,511 | 10,328 | (817) |
| Total policy acquisition and other underwriting | 13,625 | 13,441 | 184 | 39,816 | 39,149 | 667 |

| | | | | | | |
|---|---|---|---|---|---|---|
| expenses | | | | | | |
| Agency expenses | (652) | (568) | (84) | (1,883) | (1,532) | (351) |
| Total policy acquisition and other underwriting expenses less agency expenses | $ 12,973 | $ 12,873 | $ 100 | $ 37,933 | $ 37,617 | $ 316 |
| Net insurance premiums earned | $ 39,982 | $ 37,688 | $ 2,294 | $ 116,045 | $ 109,038 | $ 7,007 |
| Expense ratio | 32.4% | 34.2% | -1.8% | 32.7% | 34.5% | -1.8% |

**Financial Advisory Segment**

Income before income taxes for the three and nine months ended September 30, 2013 were $0.1 million and $1.8 million, respectively. Rising interest rates along with increased volatility in fixed income markets in recent months have resulted in reduced sales of fixed income securities to institutional customers, some trading losses on securities held to support those sales and reduction in financial advisory fee income.

The majority of noninterest income for the three and nine months ended September 30, 2013 of $25.7 million and $77.3 million, respectively, was generated from fees and commissions earned from investment advisory and securities brokerage activities of $22.3 million and $70.3 million, respectively. Additionally, changes in the fair values of derivatives during the three and nine months ended September 30, 2013 produced net gains of $3.2 million and $8.8 million, respectively. Changes in the fair value of the trading portfolio produced gains of $0.2 million during the three months ended September 30, 2013 and losses of $1.7 million during the nine months ended September 30, 2013.

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Noninterest expenses were $28.3 million and $84.9 million for the three and nine months ended September 30, 2013, respectively. Employees compensation and benefits and occupancy and equipment accounted for the majority of the costs incurred.

***Financial Condition***

The following discussion contains a more detailed analysis of our financial condition at September 30, 2013 as compared to December 31, 2012.

**Securities Portfolio**

At September 30, 2013, investment securities consisted of securities of the U.S. Treasury, U.S. government and its agencies, obligations of municipalities and other political subdivisions, primarily in the State of Texas, mortgage-backed, corporate debt, and equity securities, a note receivable and a warrant. We have the ability to categorize investments as trading, available for sale, and held to maturity.

The securities portfolio consists of two major components: trading securities and securities available for sale. Trading securities are bought and held principally for the purpose of selling them in the near term and are carried at fair value, marked to market through operations and held at the Bank and First Southwest. Securities that may be sold in response to changes in market interest rates, changes in securities prepayment risk, increases in loan demand, general liquidity needs and other similar factors are classified as available for sale and are carried at estimated fair value, with unrealized gains and losses recorded in accumulated other comprehensive income.

The table below summarizes our securities portfolio (in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| **Trading securities, at fair value** | $ 43,254 | $ 90,113 |
| | | |
| **Securities available for sale, at fair value** | | |
| U.S. Treasury securities | 23,815 | 7,185 |
| U.S. government agencies: | | |
| Bonds | 742,663 | 526,237 |
| Residential mortgage-backed securities | 63,788 | 18,893 |
| Collateralized mortgage obligations | 130,534 | 97,924 |
| Corporate debt securities | 78,361 | 87,177 |
| States and political subdivisions | 158,818 | 175,759 |
| Commercial mortgage-backed securities | 804 | 1,073 |
| Equity securities | 20,996 | 20,428 |
| Note receivable | 48,487 | 44,160 |
| Warrant | 11,115 | 12,117 |
| **Total securities portfolio** | $ 1,322,635 | $ 1,081,066 |

We had net unrealized losses of $26.5 million and net unrealized gains of $12.5 million related to the available for sale investment portfolio at September 30, 2013 and December 31, 2012, respectively. The significant increase in the net unrealized loss position of our available for sale investment portfolio during 2013 was due to effects of an increase in market interest rates since May that resulted in a decrease in the fair value of our debt securities.

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*Hilltop*

Available for sale securities at September 30, 2013 include Hilltop s note receivable and warrant with SWS Group, Inc. of $59.6 million and equity securities of $8.2 million representing those shares of SWS common stock held by Hilltop.

*Banking Segment*

The banking segment s securities portfolio plays a role in the management of our interest rate sensitivity and generates additional interest income. In addition, the securities portfolio is used to meet collateral requirements for public and trust deposits, securities sold under agreements to repurchase and other purposes. The available for sale securities portfolio serves as a source of liquidity. Historically, the Bank s policy has been to invest primarily in securities of the U.S. government and its agencies, obligations of municipalities in the State of Texas and other high grade fixed income securities to minimize credit risk. At September 30, 2013, the banking segment s securities portfolio of $1.1 billion was comprised of trading securities of $21.3 million and available for sale securities of $1.1 billion. The banking segment s portfolio at September 30, 2013 included available for sale securities acquired in connection with the FNB Transaction with a book value of $193.6 million. Subsequent to September 30, 2013, securities acquired in the FNB Transaction with a book value of $130.3 million were sold.

*Insurance Segment*

Our insurance segment s primary investment objective is to preserve capital and manage for a total rate of return. NLC s strategy is to purchase securities in sectors that represent the most attractive relative value. Our insurance segment invests the premiums it receives from policyholders until they are needed to pay policyholder claims or other expenses. At September 30, 2013, the insurance segment s securities portfolio was comprised of $133.3 million in available for sale securities.

*Financial Advisory Segment*

Our financial advisory segment holds securities to support sales, underwriting and other customer activities. Because FSC is a broker-dealer, it is required to carry its securities at fair value and record changes in the fair value of the portfolio in operations. Accordingly, FSC classifies its securities portfolio of $22.0 million as trading.

**Non-Covered Loan Portfolio**

Consolidated non-covered loans held for investment are detailed in the table below and classified by portfolio segment (in thousands).

| September 30, 2013 | Loans, excluding PCI Loans | PCI Loans | Total Loans |
|---|---|---|---|
| Commercial and industrial | $ 1,566,915 | $ 58,507 | $ 1,625,422 |
| Real estate | 1,275,341 | 46,713 | 1,322,054 |
| Construction and land development | 285,751 | 24,641 | 310,392 |
| Consumer | 42,993 | 9,363 | 52,356 |
| Loans, gross | 3,171,000 | 139,224 | 3,310,224 |
| Allowance for loan losses | (30,169) | (3,011) | (33,180) |
| Loans, net of allowance | $ 3,140,831 | $ 136,213 | $ 3,277,044 |

| December 31, 2012 | Loans, excluding PCI Loans | PCI Loans | Total Loans |
|---|---|---|---|
| Commercial and industrial | $ 1,588,907 | $ 71,386 | $ 1,660,293 |
| Real estate | 1,122,667 | 62,247 | 1,184,914 |
| Construction and land development | 247,413 | 33,070 | 280,483 |
| Consumer | 26,629 | 77 | 26,706 |
| Loans, gross | 2,985,616 | 166,780 | 3,152,396 |
| Allowance for loan losses | (3,409) | | (3,409) |
| Loans, net of allowance | $ 2,982,207 | $ 166,780 | $ 3,148,987 |

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*Banking Segment*

The non-covered loan portfolio constitutes the major earning asset of the banking segment and typically offers the best alternative for obtaining the maximum interest spread above the banking segment s cost of funds. The overall economic strength of the banking segment generally parallels the quality and yield of its loan portfolio.

The banking segment s total non-covered loans, net of the allowance for non-covered loan losses, were $4.2 billion and $4.1 billion at September 30, 2013 and December 31, 2012, respectively. The banking segment s non-covered loan portfolio includes a $1.3 billion warehouse line of credit extended to PrimeLending, of which $0.9 billion was drawn at September 30, 2013, and is eliminated from net loans on our consolidated balance sheets. Prior to September 2013, this warehouse line of credit had $1.6 billion of availability, of which $1.3 billion was drawn at December 31, 2012.

The banking segment does not generally participate in syndicated loan transactions and has no foreign loans in its portfolio. At September 30, 2013, the banking segment s only non-covered loan concentration (loans to borrowers engaged in similar activities) that exceeded 10% of its total non-covered loans was non-construction commercial real estate loans within our non-covered real estate portfolio. At September 30, 2013, non-construction commercial real estate loans were 31.46% of the banking segment s total non-covered loans. The banking segment s non-covered loan concentrations were within regulatory requirements at September 30, 2013.

*Mortgage Origination Segment*

The loan portfolio of the mortgage origination segment consists of loans held for sale, primarily single-family residential mortgages funded through PrimeLending, and pipeline loans, which are loans in various stages of the application process, but not yet closed and funded. Pipeline loans may not close if potential borrowers elect in their sole discretion not to proceed with the loan application. Total loans held for sale were $1.0 billion and $1.4 billion at September 30, 2013 and December 31, 2012, respectively.

The components of the mortgage origination segment s loans held for sale and pipeline loans are as follows (in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Loans held for sale: | | |
| Unpaid principal balance | $ 1,002,490 | $ 1,359,829 |
| Fair value adjustment | 43,662 | 40,908 |
| | $ 1,046,152 | $ 1,400,737 |
| | | |
| Pipeline loans: | | |
| Unpaid principal balance | $ 695,183 | $ 968,083 |
| Fair value adjustment | 25,524 | 15,150 |
| | $ 720,707 | $ 983,233 |

*Financial Advisory Segment*

The loan portfolio of the financial advisory segment consists primarily of margin loans to customers and correspondents. These loans are collateralized by the securities purchased or by other securities owned by the clients and, because of collateral coverage ratios, are believed to present minimal collectability exposure. Additionally, these loans are subject to a number of regulatory requirements as well as FSC s internal policies. The financial advisory segment s total non-covered loans, net of the allowance for non-covered loan losses, were $286.7 million and $277.0 million at September 30, 2013 and December 31, 2012, respectively. This increase was primarily attributable to increased borrowings in margin accounts held by FSC customers and correspondents.

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**Covered Loan Portfolio**

*Banking Segment*

Loans acquired in the FNB Transaction are subject to loss-share agreements with the FDIC and are referred to as covered loans and reported separately in our consolidated balance sheets. Under the terms of the loss-share agreements, the FDIC has agreed to reimburse the Bank for: (i) 80% of losses on the first $240.4 million of losses incurred; (ii) 0% of losses in excess of $240.4 million up to and including $365.7 million of losses incurred; and (iii) 80% of losses in excess of $365.7 million of losses incurred. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. 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 Bank acquired loans both with and without evidence of credit quality deterioration since origination. Based on preliminary purchase date valuations, the banking segment s portfolio of acquired covered loans had a fair market value of $1.1 billion as of the Bank Closing Date, with no carryover of any allowance for loan losses. Given the short period of time that has elapsed since the Bank Closing Date, significant estimates and assumptions were used to preliminarily value the covered loan portfolio and the fair value of the covered loans shown at September 30, 2013 is equal to its carrying value.

Covered loans summarized by portfolio segment at September 30, 2013 are as follows (in thousands).

| | | |
|---|---|---|
| Commercial and industrial | $ | 74,581 |
| Real estate | | 833,493 |
| Construction and land development | | 188,505 |
| Consumer | | 11 |
| Total covered loans | $ | 1,096,590 |

At September 30, 2013, the banking segment had covered loan concentrations (loans to borrowers engaged in similar activities) that exceeded 10% of total covered loans in its real estate portfolio. The areas of concentration within our covered real estate portfolio were construction and land development loans, non-construction residential real estate loans, and non-construction commercial real estate loans. At September 30, 2013, construction and land development loans, non-construction residential real estate loans, and non-construction commercial real estate loans were 22.53%, 27.26% and 36.56%, respectively, of the banking segment s total covered loans. The banking segment s covered loan concentrations were within regulatory requirements at September 30, 2013.

**Allowance for Loan Losses**

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 our existing non-covered and covered loan portfolios. Our 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 our 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 we 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.

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We have 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 our 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 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.

We design our loan review program to identify and monitor problem loans by maintaining a credit grading process, requiring that timely and appropriate changes are 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. We review on an individual basis all loan relationships over $0.5 million that exhibit probable or observed credit weaknesses, the top 25 loan relationships by dollar amount in each market we serve, and additional relationships necessary to achieve adequate coverage of our various lending markets.

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 September 30, 2013, we had no material delinquencies in these types of loans.

The allowance is subject to regulatory examination and determination as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance. While we believe we have an appropriate allowance for our existing non-covered and covered portfolios at September 30, 2013, additional provisions for losses on existing loans may be necessary in the future. Within our non-covered portfolio, we recorded net charge-offs in the amount of $3.7 million and $5.2 million for the three and nine months ended September 30, 2013, respectively. Our allowance for non-covered loan losses totaled $33.2 million and $3.4 million at September 30, 2013 and December 31, 2012, respectively. The ratio of the allowance for non-covered loan losses to total non-covered loans held for investment at September 30, 2013 and December 31, 2012 was 1.00% and 0.11%, respectively. There were no specific reserves in the allowance for loan losses related to covered impaired loans at September 30, 2013.

In connection with the PlainsCapital Merger and the FNB Transaction, we acquired loans both with and without evidence of credit quality deterioration since origination. The acquired loans were initially recorded at fair value with no carryover of any allowance for loan losses. Given the short period of time that has elapsed since the Bank Closing Date, significant estimates and assumptions were used to preliminarily value the covered loan portfolio and the fair value of the covered loans shown at September 30, 2013 is equal to its carrying value.

Provisions for loan losses are charged to operations to record the total allowance for loan losses at a level deemed appropriate by the banking segment s management based on such factors as the volume and type of lending it conducted, the amount of non-performing loans and related collateral security, the present level of the allowance for loan losses, the results of recent regulatory examinations, generally accepted accounting principles, general economic conditions and other factors related to the ability to collect loans in its portfolio. The provision for non-covered loan losses, primarily in the banking segment, was $10.7 million and $35.0 million for the three and nine months ended September 30, 2013, respectively.

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The following table presents the activity in our allowance for non-covered loan losses for the periods presented (in thousands). Substantially all of the activity shown below occurred within the banking segment, which was acquired as a part of the PlainsCapital Merger.

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|---|---|
| Balance, beginning of period | $ 26,237 | $ 3,409 |
| Provisions charged to operating expenses | 10,658 | 34,952 |
| Recoveries of non-covered loans previously charged off: | | |
| Commercial and industrial | 42 | 2,457 |
| Real estate | 26 | 227 |
| Construction and land development | 2 | 153 |
| Consumer | 15 | 43 |
| Total recoveries | 85 | 2,880 |
| Non-covered loans charged off: | | |
| Commercial and industrial | 3,220 | 7,314 |
| Real estate | 53 | 149 |
| Construction and land development | 524 | 524 |
| Consumer | 3 | 74 |
| Total charge-offs | 3,800 | 8,061 |
| Net charge-offs | (3,715) | (5,181) |
| Balance, end of period | $ 33,180 | $ 33,180 |

The distribution of the allowance for non-covered loan losses among non-covered loan types and the percentage of the non-covered loans for that type to gross non-covered loans, excluding unearned income, are presented in the table below (dollars in thousands).

| | September 30, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Reserve | % of Gross Non-Covered Loans | Reserve | % of Gross Non-Covered Loans |
| Commercial and industrial | $ 19,507 | 49.10% | $ 1,845 | 52.67% |
| Real estate (including construction and land development) | 13,622 | 49.32% | 1,559 | 46.48% |
| Consumer | 51 | 1.58% | 5 | 0.85% |
| Total | $ 33,180 | 100.00% | $ 3,409 | 100.00% |

*Potential Problem Loans*

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which management has concerns about the ability of an obligor to continue to comply with repayment terms because of the obligor s potential operating or financial difficulties. Management monitors these loans and reviews their performance on a regular basis. Potential problem loans contain potential weaknesses that could improve, persist or further deteriorate. If such potential weaknesses persist without improving, the loan is subject to downgrade, typically to substandard, in three to six months. Within our non-covered loan portfolio at September 30, 2013, we had five credit relationships totaling $7.7 million of potential problem loans, which are assigned a grade of special mention within our risk grading matrix. At December 31, 2012, we had four credit relationships totaling $2.7 million of non-covered potential problem loans. Given the short period of time that has elapsed since the Bank Closing Date, the Bank s ongoing review of potential problem loans acquired in the FNB Transaction and the resulting

determination of internal risk grades remains outstanding at September 30, 2013.

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*Non-Performing Assets*

The following table presents our components of non-covered non-performing assets (dollars in thousands).

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Non-covered loans accounted for on a non-accrual basis: | | |
| Commercial and industrial | $ 16,122 | $ |
| Real estate | 4,691 | 1,756 |
| Construction and land development | 1,073 | |
| Consumer | | |
| | $ 21,886 | $ 1,756 |
| | | |
| Non-covered non-performing loans as a percentage of total non-covered loans | 0.50% | 0.04% |
| | | |
| Non-covered other real estate owned | $ 6,989 | $ 11,098 |
| | | |
| Other repossessed assets | $ 1,601 | $ 557 |
| | | |
| Non-covered non-performing assets | $ 30,476 | $ 13,411 |
| | | |
| Non-covered non-performing assets as a percentage of total assets | 0.34% | 0.18% |
| | | |
| Non-covered loans past due 90 days or more and still accruing | $ 1,128 | $ 2,000 |
| | | |
| Troubled debt restructurings included in accruing non-covered loans | $ 1,180 | $ |

At September 30, 2013, total non-covered non-performing assets increased $17.1 million to $30.5 million, compared with $13.4 million at December 31, 2012, primarily due to an increase in non-covered non-accrual PCI loans of $18.1 million. Non-covered non-performing loans totaled $21.9 million at September 30, 2013 and $1.8 million at December 31, 2012. At September 30, 2013, non-covered non-accrual loans included 13 commercial and industrial relationships with loans totaling $15.9 million secured by accounts receivable, inventory and equipment, and a total of $0.2 million in lease financing receivables. Non-covered non-accrual loans at September 30, 2013 also included $4.7 million characterized as real estate loans, including five commercial real estate loan relationships totaling $2.0 million and loans secured by residential real estate totaling $2.7 million, substantially all of which were classified as loans held for sale, as well as construction and land development loans of $1.1 million. At December 31, 2012, non-covered non-accrual loans of $1.8 million included real estate loans secured by residential real estate and classified as loans held for sale. Non-covered OREO decreased $4.1 million to $7.0 million at September 30, 2013, compared with $11.1 million at December 31, 2012. The decrease was primarily due to the disposal of two properties totaling $2.5 million. At September 30, 2013, non-covered OREO included commercial properties of $6.7 million, commercial real estate property consisting of parcels of unimproved land of $0.2 million and residential lots under development of $0.1 million.

At September 30, 2013, troubled debt restructurings ( TDRs ) totaled $11.4 million, all of which relate to modifications of non-covered PCI loans. These TDRs were comprised of $1.2 million of non-covered PCI loans that are considered to be performing due to the application of the accretion method and non-covered non-performing PCI loans of $10.2 million for which discount accretion has been suspended because the extent and timing of cash flows from these non-covered PCI loans can no longer be reasonably estimated.

OREO acquired in the FNB Transaction that is subject to the FDIC loss-share agreements is referred to as covered OREO and reported separately in our consolidated balance sheets. At September 30, 2013, covered OREO was $119.7 million and included commercial properties of $72.1 million, commercial real estate property consisting of parcels of unimproved land of $25.8 million and residential lots under development of $21.8 million.

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**Reserve for Unpaid Losses and Loss Adjustment Expenses**

At September 30, 2013 and December 31, 2012, our reserves for unpaid losses and LAE were $31.3 million and $34.0 million, respectively. The liability for insurance losses and LAE represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims that have not yet been reported. Separately for each of NLIC and ASIC and each line of business, our actuaries estimate the liability for unpaid losses and LAE by first estimating ultimate losses and LAE amounts for each year, prior to recognizing the impact of reinsurance.

Insured losses for a given accident year change in value over time as additional information on claims is received, as claim conditions change and as new claims are reported. This process is commonly referred to as loss development. To project ultimate losses and LAE, our actuaries examine the paid and reported losses and LAE for each accident year and multiply these values by a loss development factor. The selected loss development factors are based upon a review of the loss development patterns indicated in the companies historical loss triangles and applicable insurance industry loss development factors.

The reserve analysis performed by our actuaries provides preliminary central estimates of the unpaid losses and LAE. At each quarter-end, the results of the reserve analysis are summarized and discussed with our senior management. The senior management group considers many factors in determining the amount of reserves to record for financial statement purposes. These factors include the extent and timing of any recent catastrophic events, historical pattern and volatility of the actuarial indications, the sensitivity of the actuarial indications to changes in paid and reported loss patterns, the consistency of claims handling processes, the consistency of case reserving practices, changes in our pricing and underwriting, and overall pricing and underwriting trends in the insurance market.

**Borrowings**

Our borrowings are shown in the table below (dollars in thousands).

| | September 30, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Balance | Average Rate Paid | Balance | Average Rate Paid |
| Short-term borrowings | $ 305,297 | 0.36% | $ 728,250 | 0.33% |
| Notes payable | 140,111 | 6.58% | 141,539 | 5.89% |
| Junior subordinated debentures | 67,012 | 3.61% | 67,012 | 3.53% |
| | $ 512,420 | 1.79% | $ 936,801 | 1.40% |

Short-term borrowings consist of federal funds purchased, securities sold under agreements to repurchase, borrowings at the Federal Home Loan Bank ( FHLB ) and short-term bank loans. The $423.0 million decrease in short-term borrowings at September 30, 2013 compared with December 31, 2012 included decreases of $250.0 million in borrowings at the FHLB and $177.8 million in federal funds purchased. These decreases were primarily the result of lower funding requirements due to a reduction in our mortgage origination segment s balance on its warehouse line of credit with the Bank. Notes payable is comprised of 7.50% Senior Exchangeable Notes due 2025 (the Notes ) at HTH Operating Partnership LP ( OP ), a wholly owned subsidiary of Hilltop, which were called for redemption on October 15, 2013, insurance segment term notes and nonrecourse notes owed by First Southwest.

***Liquidity and Capital Resources***

Hilltop is a financial holding company whose assets primarily consist of the stock of its subsidiaries and invested assets with a combined value of $9.1 billion at September 30, 2013. Hilltop s primary investment objectives, as a holding company, are to preserve capital and have available cash resources to utilize in making acquisitions. At September 30, 2013, Hilltop had approximately $177 million in freely available cash and cash equivalents. This decrease from the $205 million balance at June 30, 2013 primarily resulted from Hilltop s $35 million capital investment in our subsidiary, PlainsCapital Bank, to provide additional capital in connection with the FNB Transaction on September 13, 2013. If necessary or appropriate, we may also finance acquisitions with the proceeds from equity or debt issuances. The current short-term liquidity needs of Hilltop include operating expenses, debt service and dividends on preferred stock.

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On October 15, 2013, OP called for redemption all of its outstanding Notes on November 14, 2013 (the Redemption Date ). At October 15, 2013, OP had $90.9 million in aggregate principal amount of Notes outstanding, including $6.9 million aggregate principal amount held by our insurance company subsidiaries. The Notes will be redeemed at a redemption price equal to the principal amount of the Notes, plus accrued and unpaid interest up to, but excluding, the Redemption Date.

At any time prior to the Redemption Date, holders may exchange their Notes into shares of Hilltop common stock at the rate of 73.94998 shares per $1,000 principal amount of the Notes (or approximately $13.52 per share). In lieu of delivery of Hilltop common stock upon the exercise of a holder of its exchange right, OP may elect to pay such holder of the Notes an amount in cash (or a combination of Hilltop common stock and cash) in respect of all or a portion of such holder s Notes equal to the closing price of Hilltop s common stock for the five consecutive trading days commencing on and including the third business day following the exercise of such exchange right. As of November 8, 2013, such redemptions resulted in the issuance of 2,896,316 shares of Hilltop common stock. As of November 8, 2013, Notes with an aggregate principal amount of $51.7 million remained outstanding, including $6.9 million of Notes held by our insurance company subsidiaries.

During September 2013, Hilltop and PlainsCapital contributed capital of $35.0 million and $25.0 million, respectively, to the Bank to provide additional capital in connection with the FNB Transaction.

Within our banking segment, liquidity refers to the measure of our ability to meet our customers short-term and long-term deposit withdrawals and anticipated and unanticipated increases in loan demand without penalizing earnings. Interest rate sensitivity involves the relationships between rate-sensitive assets and liabilities and is an indication of the probable effects of interest rate fluctuations on our net interest income.

Our asset and liability group is responsible for continuously monitoring our liquidity position to ensure that assets and liabilities are managed in a manner that will meet our short-term and long-term cash requirements. Funds invested in short-term marketable instruments, the continuous maturing of other interest-earning assets, cash flows from self-liquidating investments such as mortgage-backed securities and collateralized mortgage obligations, the possible sale of available for sale securities, and the ability to securitize certain types of loans provide sources of liquidity from an asset perspective. The liability base provides sources of liquidity through deposits and the maturity structure of short-term borrowed funds. For short-term liquidity needs, we utilize federal fund lines of credit with correspondent banks, securities sold under agreements to repurchase, borrowings from the Federal Reserve and borrowings under lines of credit with other financial institutions. For intermediate liquidity needs, we utilize advances from the FHLB. To supply liquidity over the longer term, we have access to brokered certificates of deposit, term loans at the FHLB and borrowings under lines of credit with other financial institutions.

As a result of the PlainsCapital Merger, the outstanding shares of PlainsCapital Corporation s Non-Cumulative Perpetual Preferred Stock, Series C, all of which were held by the U.S. Department of the Treasury, were converted on a one-for-one basis into shares of Hilltop Series B Preferred Stock. Holders of the Hilltop Series B Preferred Stock are entitled to noncumulative cash dividends at a fluctuating dividend rate based on the Bank s level of qualified small business lending ( QSBL ). The terms of our Series B Preferred Stock provide for the payment of non-cumulative dividends on a quarterly basis. The dividend rate, as a percentage of the liquidation amount, fluctuates while the Hilltop Series B Preferred Stock is outstanding based upon changes in the level of QSBL by the Bank from its historical average level of QSBL at the end of each of the four quarters leading up to June 30, 2010 (the Baseline ). Until March 2016, the dividend rate will generally decrease if we increase our level of QSBL from the Baseline and increase if we decrease our level of QSBL from the Baseline, subject to certain limitations described in the Articles Supplementary governing Hilltop s Series B Preferred Stock. The shares of Hilltop Series B Preferred Stock are senior to shares of our common stock with respect to dividends and liquidation preference, and qualify as Tier 1 Capital for regulatory purposes. At September 30, 2013 and December 31, 2012, $114.1 million of our Series B Preferred Stock was outstanding. During the three months ended September 30, 2013, we accrued dividends of $1.1 million on the Hilltop Series B Preferred Stock.

The dividend rate on the Hilltop Series B Preferred Stock was 3.974% for the three months ended September 30, 2013. The dividend rate for the period from October 1, 2013 to December 31, 2013 increased to 4.706% due to a decrease in the level of QSBL at June 30, 2013, relative to the Baseline. Subject to the approval of Treasury, we expect the dividend rate for the period from January 1, 2014 to March 26, 2016 to be 5.000%. In addition, beginning on January 1, 2014 and on all dividend payment dates thereafter ending on April 1, 2016, if the Bank fails to increase its level of QSBL compared to the Baseline, we will be required to pay a quarterly lending incentive fee of 0.5% of the liquidation value of the Hilltop Series B Preferred Stock.

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In connection with the FNB Transaction, the Bank entered into two loss-share agreements with the FDIC that collectively cover approximately $1.2 billion of loans and OREO acquired in the FNB Transaction. Pursuant to the loss-share agreements, the FDIC has agreed to reimburse the Bank the following amounts with respect to the covered assets: (i) 80% of losses on the first $240.4 million of losses incurred; (ii) 0% of losses in excess of $240.4 million up to and including $365.7 million of losses incurred; and (iii) 80% of losses in excess of $365.7 million of losses incurred. The Bank has also agreed to reimburse the FDIC for any subsequent recoveries. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, from the Bank Closing Date and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. 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.

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements may prompt certain actions by regulators that, if undertaken, could have a direct material adverse effect on our financial condition and results of operations. Under capital adequacy and regulatory requirements, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

At September 30, 2013, Hilltop exceeded all regulatory capital requirements with a total capital to risk weighted assets ratio of 17.14%, Tier 1 capital to risk weighted assets ratio of 16.56% and a Tier 1 capital to average assets, or leverage, ratio of 13.96%. At September 30, 2013, the Bank was also considered to be well-capitalized under regulatory requirements.

Cash and cash equivalents (consisting of cash and due from banks and federal funds sold), totaled $1.0 billion at September 30, 2013, an increase of $289.8 million from $726.5 million at December 31, 2012. Deposit flows, calls of investment securities and borrowed funds, and prepayments of loans and mortgage-backed securities are strongly influenced by interest rates, general and local economic conditions and competition in the marketplace. These factors reduce the predictability of the timing of these sources of funds.

Cash provided by operations during the nine months ended September 30, 2013 was $462.7 million, an increase in cash flow of $476.0 million compared with the same period in 2012. Cash provided by operations increased primarily due to the PlainsCapital Merger on November 30, 2012 and inclusion of operating activities of the banking, mortgage origination and financial advisory segments during the nine months ended September 30, 2013.

Cash provided by our investment activities during the nine months ended September 30, 2013 was $257.5 million, including $362.7 million in net cash from the FNB Transaction, partially offset by $49.3 million for the origination of loans held for investment and net purchases of securities for our investment portfolio of $43.4 million. Proceeds from investment portfolio activity provided $10.3 million during the nine months ended September 30, 2012.

Cash used in financing activities during the nine months ended September 30, 2013 was $430.3 million, an increase in cash used of $429.2 million compared with the same period in 2012. This increase in cash used was due primarily to the PlainsCapital Merger on November 30, 2012 and the inclusion of financing activities of the banking segment for the nine months ended September 30, 2013.

We had deposits of $6.9 billion at September 30, 2013, an increase of $2.2 billion compared with December 31, 2012. Deposit flows are affected by the level of market interest rates, the interest rates and products offered by competitors, the volatility of equity markets and other factors. In particular, our deposits at September 30, 2013 increased compared to our deposits at December 31, 2012 primarily due to the inclusion of assumed FNB Transaction deposits within the banking segment. At September 30, 2013, money market deposits, including brokered deposits, were $3.2 billion, time deposits, including brokered deposits, were $2.6 billion, and noninterest bearing demand deposits were $392.4 million.

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Our 15 largest depositors, excluding Hilltop and our indirect wholly owned subsidiary, First Southwest, accounted for 13.25% of our total deposits, and our five largest depositors, excluding First Southwest, accounted for 8.09% of our total deposits at September 30, 2013. The loss of one or more of our largest customers, or a significant decline in the deposit balances due to ordinary course fluctuations related to these customers businesses, could adversely affect our liquidity and might require us to raise deposit rates to attract new deposits, purchase federal funds or borrow funds on a short-term basis to replace such deposits. We have not experienced any liquidity issues to date with respect to brokered deposits or our other large balance deposits, and we believe alternative sources of funding are available to more than compensate for the loss of one or more of these customers.

PrimeLending funds the mortgage loans it originates through a warehouse line of credit of up to $1.3 billion maintained with the Bank. At September 30, 2013, PrimeLending had outstanding borrowings of $0.9 billion against the warehouse line of credit. PrimeLending sells substantially all mortgage loans it originates to various investors in the secondary market with servicing released, although it may retain servicing in certain circumstances. As these mortgage loans are sold in the secondary market, PrimeLending pays down its warehouse line of credit with the Bank. In addition, PrimeLending has an available line of credit with JPMorgan Chase Bank, NA ( JPMorgan Chase ) of up to $1.0 million. At September 30, 2013, PrimeLending had no borrowings under the JPMorgan Chase line of credit.

FSC relies on its equity capital, short-term bank borrowings, interest-bearing and non-interest-bearing client credit balances, correspondent deposits, securities lending arrangements, repurchase agreement financings and other payables to finance its assets and operations. FSC has credit arrangements with three unaffiliated banks of up to $255.0 million, which are used to finance securities owned, securities held for correspondent accounts and receivables in customer margin accounts. These credit arrangements are provided on an as offered basis and are not committed lines of credit. At September 30, 2013, FSC had borrowed $92.2 million under these credit arrangements.

Our insurance operating subsidiary s primary investment objectives is to preserve capital and manage for a total rate of return. NLC s strategy is to purchase securities in sectors that represent the most attractive relative value. Bonds, cash, and short-term investments of $193.0 million, or 93.8%, and equity investments of $12.8 million comprised NLC s $205.8 million in total investments at September 30, 2013. NLC does not currently have any significant concentration in both direct and indirect guarantor exposure or any investments in subprime mortgages. NLC has custodial agreements with Wells Fargo and an investment management agreement with DTF Holdings, LLC.

***Impact of Inflation and Changing Prices***

Our consolidated financial statements included herein have been prepared in accordance with GAAP, which presently require us to measure financial position and operating results primarily in terms of historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on our operations is reflected in increased operating costs. In management s opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond our control, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the U.S. government, its agencies and various other governmental regulatory authorities.

***Off-Balance Sheet Arrangements; Commitments; Guarantees***

In the normal course of business, we enter into various transactions, which, in accordance with GAAP, are not included in our consolidated balance sheets. We enter into these transactions to meet the financing needs of our customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in our consolidated balance sheets.

We enter into contractual loan commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of our commitments to extend credit are contingent upon customers maintaining specific credit standards until the time of loan funding. We minimize our exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures. We assess the credit risk associated with certain commitments to extend credit and have recorded a liability related to such credit risk in our consolidated financial statements.

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Standby letters of credit are written conditional commitments issued by us to guarantee the performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, we would be required to fund the commitment. The maximum potential amount of future payments we could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, we would be entitled to seek recovery from the customer. Our policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

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.

***Critical Accounting Policies and Estimates***

Our accounting policies are fundamental to understanding our management s discussion and analysis of our results of operations and financial condition. We have identified certain policies as being significant because they involve a higher degree of judgment and complexity in making certain estimates and assumptions that affect amounts reported in our consolidated financial statements. These policies relate to Allowance for Loan Losses, Reserve for Losses and Loss Adjustment Expenses, Goodwill and Identifiable Intangible Assets, Loan Indemnification Liability and Acquisition Accounting. Since December 31, 2012, there have been no changes in critical accounting policies as further described under Critical Accounting Policies and Estimates and Note 1 to the Consolidated Financial Statements in the Company s 2012 Annual Report on Form 10-K, except as follows.

*FDIC Indemnification Asset*

We have elected to account for amounts receivable under the loss-share agreements as an indemnification asset (the FDIC Indemnification Asset ) in accordance with FASB ASC 805. The FDIC Indemnification Asset is initially recorded at fair value, based on the discounted value of expected future cash flows under the loss-share agreements. The difference between the present value and the undiscounted cash flows we expect to collect from the FDIC will be accreted into noninterest income within the consolidated statements of operations over the life of the FDIC Indemnification Asset. The FDIC Indemnification Asset is reviewed quarterly and adjusted for any changes in expected cash flows based on recent performance and expectations for future performance of the covered portfolio. These adjustments are measured on the same basis as the related covered loans and covered OREO. Any increases in cash flow of the covered assets over those expected will reduce the FDIC Indemnification Asset and any decreases in cash flow of the covered assets under those expected will increase the FDIC Indemnification Asset. Any amortization of changes in value is limited to the contractual terms of the loss-share agreements. Increases and decreases to the FDIC Indemnification Asset are recorded as adjustments to noninterest income within the consolidated statements of operations over the life of the loss-share agreements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

The primary objective of the following information is to provide forward-looking quantitative and qualitative information about our potential exposure to market risks. The disclosure is not meant to be a precise indicator of expected future losses, but rather an indicator of reasonably

possible losses, and therefore our actual results may differ from any of the following projections. This forward-looking information provides an indicator of how we view and manage our ongoing market risk exposures.

The banking segment is engaged primarily in the business of investing funds obtained from deposits and borrowings in interest-earning loans and investments, and our primary component of market risk is interest rate volatility. Consequently, our earnings depend to a significant extent on our net interest income, which is the difference between interest income on loans and investments and our interest expense on deposits and borrowings. To the extent that our interest-bearing liabilities do not reprice or mature at the same time as our interest-bearing assets, we are subject to interest rate risk and corresponding fluctuations in net interest income.

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Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The magnitude of the change in earnings and market value of equity resulting from interest rate changes is impacted by the time remaining to maturity on fixed-rate obligations, the contractual ability to adjust rates prior to maturity, competition, the general level of interest rates and customer actions. Our objective is to measure the effect of interest rate changes on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income.

There are several common sources of interest rate risk that must be effectively managed if there is to be minimal impact on our earnings and capital. Repricing risk arises largely from timing differences in the pricing of assets and liabilities. Reinvestment risk refers to the reinvestment of cash flows from interest payments and maturing assets at lower or higher rates. Basis risk exists when different yield curves or pricing indices do not change at precisely the same time or in the same magnitude such that assets and liabilities with the same maturity are not all affected equally. Yield curve risk refers to unequal movements in interest rates across a full range of maturities.

We have employed asset/liability management policies that attempt to manage our interest-earning assets and interest-bearing liabilities, thereby attempting to control the volatility of net interest income, without having to incur unacceptable levels of credit or investment risk. We employ procedures which include interest rate shock analysis, maturity gap analysis and balance sheet decomposition techniques help mitigate interest rate risk in the ordinary course of business. In addition, the asset/liability management policies permit the use of various derivative instruments to manage interest rate risk or hedge specified assets and liabilities.

An interest rate sensitive asset or liability is one that, within a defined time period, either matures or experiences an interest rate change in line with general market interest rates. The management of interest rate risk is performed by analyzing the maturity and repricing relationships between interest-earning assets and interest-bearing liabilities at specific points in time ( GAP ) and by analyzing the effects of interest rate changes on net interest income over specific periods of time by projecting the performance of the mix of assets and liabilities in varied interest rate environments. Interest rate sensitivity reflects the potential effect on net interest income resulting from a movement in interest rates. A company is considered to be asset sensitive, or have a positive GAP, when the amount of its interest-earning assets maturing or repricing within a given period exceeds the amount of its interest-bearing liabilities also maturing or repricing within that time period. Conversely, a company is considered to be liability sensitive, or have a negative GAP, when the amount of its interest-bearing liabilities maturing or repricing within a given period exceeds the amount of its interest-earning assets also maturing or repricing within that time period. During a period of rising interest rates, a negative GAP would tend to affect net interest income adversely, while a positive GAP would tend to result in an increase in net interest income. During a period of falling interest rates, a negative GAP would tend to result in an increase in net interest income, while a positive GAP would tend to affect net interest income adversely. However, it is our intent to achieve a proper balance so that incorrect rate forecasts should not have a significant impact on earnings.

Interest rate sensitivity analysis presents the amount of assets and liabilities that are estimated to reprice through specified periods. The interest rate sensitivity analysis in the table below reflects changes in banking segment earnings and costs resulting from changes in assets and liabilities on September 30, 2013 that will either be repriced in accordance with market rates, mature or are estimated to mature early within the periods indicated. This is a one-day position that is continually changing and is not necessarily indicative of our position at any other time.

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As illustrated in the table below, the banking segment is asset sensitive overall. Loans that adjust daily or monthly to the Wall Street Journal Prime rate comprise a large percentage of interest sensitive assets and are the primary cause of the banking segment s asset sensitivity. To help neutralize interest rate sensitivity, the banking segment has kept the terms of most of its borrowings under one year as shown in the following table (dollars in thousands).

| | September 30, 2013 | | | | | |
|---|---|---|---|---|---|---|
| | 3 Months or Less | > 3 Months to 1 Year | > 1 Year to 3 Years | > 3 Years to 5 Years | > 5 Years | Total |
| **Interest sensitive assets:** | | | | | | |
| Loans | $ 2,631,597 | $ 550,782 | $ 682,791 | $ 255,826 | $ 946,766 | $ 5,067,762 |
| Securities | 527,138 | 58,934 | 152,473 | 44,282 | 304,956 | 1,087,783 |
| Federal funds sold and securities purchased under agreements to resell | 40,086 | | | | | 40,086 |
| Other interest sensitive assets | 535,348 | | | | | 535,348 |
| Total interest sensitive assets | 3,734,169 | 609,716 | 835,264 | 300,108 | 1,251,722 | 6,730,979 |
| | | | | | | |
| **Interest sensitive liabilities:** | | | | | | |
| Interest bearing checking | $ 2,137,981 | $ | $ | $ | $ | $ 2,137,981 |
| Savings | 450,723 | | | | | 450,723 |
| Time deposits | 856,605 | 1,093,315 | 562,777 | 92,000 | 38,042 | 2,642,739 |
| Notes payable & other borrowings | 213,261 | 505 | 1,437 | 771 | 5,474 | 221,448 |
| Total interest sensitive liabilities | 3,658,570 | 1,093,820 | 564,214 | 92,771 | 43,516 | 5,452,891 |
| | | | | | | |
| Interest sensitivity gap | $ 75,599 | $ (484,104) | $ 271,050 | $ 207,337 | $ 1,208,206 | $ 1,278,088 |
| | | | | | | |
| Cumulative interest sensitivity gap | $ 75,599 | $ (408,505) | $ (137,455) | $ 69,882 | $ 1,278,088 | |
| | | | | | | |
| Percentage of cumulative gap to total interest sensitive assets | 1.12% | -6.07% | -2.04% | 1.04% | 18.99% | |

The positive GAP in the interest rate sensitivity analysis indicates that banking segment net interest income would generally rise if rates increase. Because of inherent limitations in interest rate sensitivity analysis, the banking segment uses multiple interest rate risk measurement techniques. Simulation analysis is used to subject the current repricing conditions to rising and falling interest rates in increments and decrements of 1%, 2% and 3% to determine the effect on net interest income changes for the next twelve months. The banking segment also measures the effects of changes in interest rates on market value of equity by discounting projected cash flows of deposits and loans. Market value changes in the investment portfolio are estimated by discounting future cash flows and using duration analysis. Investment security prepayments are estimated using current market information. We believe the simulation analysis presents a more accurate picture than the GAP analysis. Simulation analysis recognizes that deposit products may not react to changes in interest rates as quickly or with the same magnitude as earning assets contractually tied to a market rate index. The sensitivity to changes in market rates varies across deposit products. Also, unlike GAP analysis, simulation analysis takes into account the effect of embedded options in the securities and loan portfolios as well as any

off-balance-sheet derivatives.

The table below shows the estimated impact of increases of 1%, 2% and 3% and a decrease of 0.5% in interest rates on net interest income and on market value of portfolio equity for the banking segment at September 30, 2013 (dollars in thousands).

| Change in Interest Rates (basis points) | Changes in Net Interest Income | | Changes in Market Value of Equity | |
|---|---|---|---|---|
| | Amount | Percent | Amount | Percent |
| +300 | $ (47,898) | -16.29% | $ 73,287 | 6.30% |
| +200 | $ (36,696) | -12.48% | $ 47,974 | 4.13% |
| +100 | $ (26,052) | -8.86% | $ 19,588 | 1.69% |
| -50 | $ 9,506 | 3.23% | $ (20,748) | -1.78% |

The projected changes in net interest income and market value of equity to changes in interest rates at September 30, 2013 were in compliance with established internal policy guidelines. These projected changes are based on numerous assumptions of growth and changes in the mix of assets or liabilities.

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The historically low level of interest rates, combined with the existence of rate floors that are in effect for a significant portion of the loan portfolio, are projected to cause yields on our earning assets to rise more slowly than increases in market interest rates. As a result, in a rising interest rate environment, our interest rate margins are projected to compress until the rise in market interest rates is sufficient to allow our loan portfolio to reprice above applicable rate floors.

Within our mortgage origination segment, our principal market exposure is to interest rate risk due to the impact on our mortgage-related assets and commitments, including mortgage loans held for sale and IRLCs. Changes in interest rates could also materially and adversely affect our volume of mortgage loan originations.

IRLCs represent an agreement to extend credit to a mortgage loan applicant, whereby the interest rate on the loan is set prior to funding. Our mortgage loans held for sale, which we hold in inventory while awaiting sale into the secondary market, and our IRLCs are subject to the effects of changes in mortgage interest rates from the date of the commitment through the sale of the loan into the secondary market. As a result, we are exposed to interest rate risk and related price risk during the period from the date of the lock commitment until (i) the lock commitment cancellation or expiration date or (ii) the date of sale into the secondary mortgage market. Loan commitments generally range from 20 to 60 days, and our average holding period of the mortgage loan from funding to sale is approximately 30 days.

The goal of our interest rate risk management strategy within our mortgage origination segment is not to eliminate interest rate risk, but to manage it within appropriate limits. To mitigate the risk of loss, we have established policies and procedures, which include guidelines on the amount of exposure to interest rate changes we are willing to accept. An integral component of our interest rate risk management strategy is our execution of forward commitments to sell mortgage-backed securities to minimize significant fluctuations in earnings caused by changes in interest rates.

At September 30, 2013, total notes payable outstanding on our consolidated balance sheet was $140.1 million, and was comprised of $83.9 million of indebtedness subject to fixed interest rates and $56.2 million subject to variable interest rates. If LIBOR and the prime rate were to increase by one eighth of one percent (0.125%), the increase in interest expense on the variable rate debt would not have a significant impact on our future consolidated earnings or cash flows.

**Item 4. Controls and Procedures**

***Evaluation of Disclosure Controls and Procedures***

Our management, with the supervision and participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report.

Based upon that evaluation, our Principal Executive Officer and Principal Financial Officer concluded that, as of the end of such period, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to

be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to the Company s management, including our Principal Executive Officer and Principal Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

***Changes in Internal Control over Financial Reporting***

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We have excluded from our evaluation the internal control over financial reporting of the assets acquired and liabilities assumed of FNB on September 13, 2013. The total assets and total income before income taxes of the excluded business represent $2.3 billion and $1.2 million, respectively, of the related consolidated financial statement amounts as of and for the nine months ended September 30, 2013.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

We are a party to various legal actions resulting from our operating activities. These actions consist of litigation and administrative proceedings arising in the ordinary course of business, some of which are covered by liability insurance, and none of which is expected to have a material adverse effect on our consolidated financial condition, results of operations or cash flows taken as a whole.

Like other financial institutions, we are subject to various federal, state and local laws and regulations relating to environmental matters. Under these laws and regulations, we could be held liable for costs relating to environmental contamination at or from properties that secure our loan portfolio. With respect to our borrower s properties, the potential liabilities may far exceed the original amount of the loan made by us and secured by the property. Currently, we are not a defendant in any environmental legal proceeding.

For additional information concerning our legal proceedings, please see the discussion under the caption Legal Proceedings set forth in Part I, Item 3 of our Annual Report on Form 10-K.

### Item 1A. Risk Factors.

***Loans acquired in the FNB transaction may not be covered by the loss-share agreements if the FDIC determines that we have not adequately managed these loans.***

Under the terms of the loss-share agreements we entered into with the FDIC in connection with the FNB transaction, the FDIC is obligated to reimburse us for the following losses on covered loans: (i) 80% of losses on the first $240.4 million of losses incurred; (ii) 0% of losses in excess of $240.4 million up to and including $365.7 million of losses incurred; and (iii) 80% of losses in excess of $365.7 million of losses incurred. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. Although the FDIC has agreed to reimburse us for the substantial portion of losses on covered loans, the FDIC has the right to refuse or delay payment for loan losses if we do not manage covered loans in accordance with the loss-share agreements. In addition, reimbursable losses are based on the book value of the relevant loans as determined by the FDIC as of the effective dates of the transactions. The amount that we realize on these loans could differ materially from the carrying value that will be reflected in our consolidated financial statements, based upon the timing and amount of collections on the covered loans in future periods. Any losses we experience in the assets acquired in the FNB transaction that are not covered under the loss-share agreements could have an adverse effect on our results of operations and financial condition.

In addition, 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.

***Income that we recognized as a bargain purchase gain in connection with the FNB Transaction is based upon a preliminary valuation and is subject to change.***

In September 2013, we assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets, of FNB from the FDIC in the FNB Transaction. We acquired approximately $2.2 billion in assets and assumed $2.2 billion in liabilities in the FNB Transaction. The FNB Transaction was accounted for under the purchase method of accounting. Based upon a preliminary valuation, we recorded a bargain purchase gain totaling $3.3 million as a result of the FNB Transaction, which was included as a component of noninterest income in our consolidated statement of operations for the three and nine months ended September 30, 2013. The amount of the gain was equal to the amount by which the estimated fair value of assets purchased exceeded the estimated fair value of liabilities assumed. The bargain purchase gain resulting from the FNB Transaction was a one-time, extraordinary gain that is not expected to be repeated in future periods. As we complete our purchase accounting, we may revise our estimates, which could result in the recognition of additional bargain purchase gain, which would be recorded as noninterest income, or the recognition of less or no bargain purchase gain, in which case we would reduce noninterest income and may be required to record goodwill that would be subject to an ongoing impairment analysis.

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***Income that we recognize in connection with the purchase discount accretion of the credit-impaired loans acquired in the PlainsCapital Merger and the FNB Transaction and accounted for under ASC 310-30 could be volatile in nature and have significant effects on reported net income.***

In connection with the PlainsCapital Merger and the FNB Transaction, we acquired loans at a discount of $146.6 million and $337.6 million, respectively. The PlainsCapital Merger and the FNB Transaction were each accounted for under the purchase method of accounting. Accordingly, these discounts are amortized and accreted to interest income on a monthly basis. The effective yield and related discount accretion on credit-impaired loans is initially determined at the acquisition date based upon estimates of the timing and amount of future cash flows as well as the amount of credit losses that will be incurred. These estimates are updated quarterly. In future periods, if actual historical results combined with future projections of these factors (amount, timing, or credit losses) differ from the initial projections, the effective yield and the amount of discount recognized will change. Volatility may increase as the variance of actual results from initial projections increases. As the acquired loans are removed from our books, the related discount will no longer be available for accretion into income. Accretion of $49.2 million on loans purchased at a discount in the PlainsCapital Merger was recorded as interest income during the nine months ended September 30, 2013, and accretion of $0.1 million on loans purchased at a discount in the FNB Transaction was recorded as interest income from September 14, 2013 to September 30, 2013. As of September 30, 2013, the balance of the carrying value of our discount on loans in the aggregate was $425.8 million.

***We may fail to realize all of the anticipated benefits of the PlainsCapital Merger or the FNB Transaction.***

The success of the PlainsCapital Merger and the FNB Transaction will depend, in part, on our ability to successfully integrate PlainsCapital Corporation s and FNB s respective operations with our own. Achieving the anticipated cost savings and financial benefits of the PlainsCapital Merger and the FNB Transaction will depend in part on whether we integrate PlainsCapital Corporation s and FNB s respective operations in an efficient and effective manner. It is possible that the integration process could result in the loss of key employees, the disruption of ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect our ability to maintain relationships with clients, customers, depositors and employees. In addition, the integration of certain operations will require the dedication of significant management resources, which may temporarily distract management s attention from our day-to-day business. With respect to the FNB Transaction, there could also be difficulties in complying with the technical requirements of the loss-share agreements with the FDIC, which could result in acquired assets losing their coverage thereunder. Any inability to realize the full extent, or any, of the anticipated cost savings and financial benefits of the PlainsCapital Merger and the FNB Transaction, as well as any delays encountered in the integration process, could have an adverse effect on our business and results of operations, which could affect our financial condition and cause a decrease in our earnings per share or decrease or delay the expected accretive effect of the FNB Transaction and contribute to a decrease in the price of our common stock.

***The Consumer Financial Protection Bureau recently issued ability-to-repay and qualified mortgage rules that may have a negative impact on our loan origination process and foreclosure proceedings, which could adversely affect our business, operating results, and financial condition.***

On January 10, 2013, the Consumer Financial Protection Bureau (the CFPB ) issued a final rule to implement the qualified mortgage provisions of the Dodd-Frank Act requiring mortgage lenders to consider consumers ability to repay home loans before extending them credit. The CFPB s qualified mortgage rule will take effect on January 10, 2014. The final rule describes certain minimum requirements for lenders making ability-to-repay determinations, but does not dictate that they follow particular underwriting models. Lenders will be presumed to have complied with the ability-to-repay rule if they issue qualified mortgages, which are generally defined as mortgage loans prohibiting or limiting certain risky features. Loans that do not meet the ability-to-repay standard can be challenged in court by borrowers who default and the absence of ability-to-repay status can be used against a lender in foreclosure proceedings. Any loans that we make outside of the qualified mortgage criteria could expose us to an increased risk of liability and reduce or delay our ability to foreclose on the underlying property. It is difficult to predict

how the CFPB s qualified mortgage rule will impact us when it takes effect, but any decreases in loan origination volume or increases in compliance and foreclosure costs caused by the rule could negatively affect our business, operating results and financial condition.

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***The impact of the changing regulatory capital requirements and new capital rules are uncertain.***

In July 2013, the Federal Reserve Board approved a final rule that will substantially amend the risk-based capital rules applicable to Hilltop and the Bank. The final rule implements the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The final rule includes new minimum risk-based capital and leverage ratios, which will be effective for Hilltop and the Bank on January 1, 2015, and refines the definition of what constitutes capital for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a capital conservation buffer of 2.5% above the new regulatory minimum capital ratios and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%; (ii) a Tier 1 to risk-based assets capital ratio of 8.5%; and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such actions. The application of more stringent capital requirements for Hilltop and the Bank could, among other things, adversely affect our results of operations and growth, require the raising of additional capital, restrict our ability to pay dividends or repurchase shares and result in regulatory actions if we were to be unable to comply with such requirements.

In addition, the Federal Reserve Board published an interim final rule in September 2013 that clarifies how companies should incorporate the Basel III regulatory capital reforms into their capital and business projections during the next cycle of capital plan submissions and stress tests. For companies and their subsidiary banks with between $10.0 billion and $50.0 billion in total consolidated assets, the initial capital planning and stress testing cycle began on October 1, 2013 and continues through the fourth quarter of 2015, which overlaps with the implementation of the Basel III capital reforms beginning on January 1, 2015. At September 30, 2013, Hilltop and the Bank had approximately $9.1 billion and $8.6 billion, respectively, in total consolidated assets. Accordingly, Hilltop and the Bank are not subject to this capital planning and stress testing cycle. If we grow to have more than $10.0 billion in assets through additional acquisitions or organic growth, we may become subject to future capital planning and stress testing cycles, which would likely increase our cost of regulatory compliance. Management continues to study the implementation of Basel III regulatory capital reforms and stress testing requirements.

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

As of November 8, 2013, Hilltop has issued 2,896,316 shares of common stock in exchange for $39.2 million aggregate principal amount of the Notes tendered for exchange (the Exchanges ). The Exchanges were exempt from registration under Section 3(a)(9) of the Securities Act of 1933, as amended (the Securities Act ), as the shares of common stock were issued to existing holders of securities guaranteed by the Company and no commission or other remuneration was paid or given for soliciting the Exchanges.

**Item 6. Exhibits**

A list of exhibits filed herewith is contained in the Exhibit Index that immediately precedes such exhibits and is incorporated by reference herein.

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**SIGNATURES**

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

**HILLTOP HOLDINGS INC.**

Date: November 12, 2013

By: /s/ Darren Parmenter
Darren Parmenter
Senior Vice President Finance
(Principal Financial and Accounting Officer and duly authorized officer)

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**EXHIBIT INDEX**

| Exhibit Number | Description of Exhibit |
|---|---|
| 2.1 | Purchase and Assumption Agreement Whole Bank, All Deposits, dated as of September 13, 2013, by and among the Federal Deposit Insurance Corporation, receiver of First National Bank, Edinburg, Texas, PlainsCapital Bank and the Federal Deposit Insurance Corporation (filed as Exhibit 2.1to the Registrant s Current Report on Form 8-K filed on September 19, 2013 (File No. 001-31987) and incorporated herein by reference). |
| 10.1 | First Supplemental Indenture, dated October 15, 2013, by and among HTH Operating Partnership LP, as issuer, Hilltop Holdings Inc., as guarantor, and U.S. Bank National Association, as trustee (filed as Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on October 17, 2013 (File No. 001-31987) and incorporated herein by reference). |
| 31.1* | Certification of Principal Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2* | Certification of Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1* | Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS** | XBRL Instance Document |
| 101.SCH** | XBRL Taxonomy Extension Schema |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase |
| 101.DEF** | XBRL Taxonomy Extension Definition Linkbase |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase |

* Filed herewith.

** In accordance with Rule 406T of Regulation S-T, the information in this exhibit is furnished and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.