

Hilltop Holdings Inc.
Form 10-Q
July 30, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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

Commission File Number: 1-31987

Hilltop Holdings Inc.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of incorporation or organization)

84-1477939
(I.R.S. Employer Identification No.)

200 Crescent Court, Suite 1330
Dallas, TX

75201

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(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 No

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 No

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	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>

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

The number of shares of the registrant's common stock outstanding at July 29, 2014 was 90,182,915.

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HILLTOP HOLDINGS INC.
FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2014

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(in thousands, except share and per share data)

	June 30, 2014 (Unaudited)	December 31, 2013
Assets		
Cash and due from banks	\$ 673,972	\$ 713,099
Federal funds sold and securities purchased under agreements to resell	14,813	32,924
Securities:		
Trading, at fair value	61,663	58,846
Available for sale, at fair value (amortized cost of \$1,205,912 and \$1,256,862, respectively)	1,201,778	1,203,143
Held to maturity, at amortized cost (fair value of \$65,631)	65,275	
	1,328,716	1,261,989
Loans held for sale	1,410,873	1,089,039
Non-covered loans, net of unearned income	3,714,837	3,514,646
Allowance for non-covered loan losses	(36,431)	(33,241)
Non-covered loans, net	3,678,406	3,481,405
Covered loans, net of allowance of \$4,115 and \$1,061, respectively	840,898	1,005,308
Broker-dealer and clearing organization receivables	190,764	119,317
Insurance premiums receivable	27,957	25,597
Deferred policy acquisition costs	22,027	20,991
Premises and equipment, net	201,545	200,706
FDIC indemnification asset	175,114	188,291
Covered other real estate owned	142,174	142,833
Mortgage servicing rights	35,877	20,149
Other assets	336,199	279,745
Goodwill	251,808	251,808
Other intangible assets, net	65,305	70,921
Total assets	\$ 9,396,448	\$ 8,904,122
Liabilities and Stockholders Equity		
Deposits:		
Noninterest-bearing	\$ 1,829,072	\$ 1,773,749
Interest-bearing	4,326,238	4,949,169
Total deposits	6,155,310	6,722,918
Broker-dealer and clearing organization payables	227,891	129,678
Reserve for losses and loss adjustment expenses	35,146	27,468
Unearned insurance premiums	94,611	88,422
Short-term borrowings	1,187,193	342,087
Notes payable	55,584	56,327
Junior subordinated debentures	67,012	67,012
Other liabilities	176,539	158,288
Total liabilities	7,999,286	7,592,200
Commitments and contingencies (see Notes 11 and 12)		
Stockholders equity:		
Hilltop stockholders equity:		
	114,068	114,068

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Preferred stock, \$0.01 par value, 10,000,000 shares authorized; Series B, liquidation value per share of \$1,000; 114,068 shares issued and outstanding			
Common stock, \$0.01 par value, 125,000,000 and 100,000,000 shares authorized; 90,180,699 and 90,175,688 shares issued and outstanding, respectively	902		902
Additional paid-in capital	1,387,883		1,388,641
Accumulated other comprehensive loss	(2,501)		(34,863)
Accumulated deficit	(103,910)		(157,607)
Total Hilltop stockholders' equity	1,396,442		1,311,141
Noncontrolling interest	720		781
Total stockholders' equity	1,397,162		1,311,922
Total liabilities and stockholders' equity	\$ 9,396,448	\$	8,904,122

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Interest income:				
Loans, including fees	\$ 92,204	\$ 65,213	\$ 171,948	\$ 130,099
Securities:				
Taxable	7,618	6,480	15,206	12,392
Tax-exempt	1,187	1,189	2,429	2,536
Federal funds sold and securities purchased under agreements to resell	14	35	33	56
Interest-bearing deposits with banks	317	242	912	575
Other	3,068	3,009	5,708	5,114
Total interest income	104,408	76,168	196,236	150,772
Interest expense:				
Deposits	3,096	3,406	6,855	6,856
Short-term borrowings	539	591	934	1,104
Notes payable	632	2,308	1,280	4,630
Junior subordinated debentures	587	612	1,171	1,220
Other	1,108	826	2,129	1,276
Total interest expense	5,962	7,743	12,369	15,086
Net interest income	98,446	68,425	183,867	135,686
Provision for loan losses	5,533	11,289	8,775	24,294
Net interest income after provision for loan losses	92,913	57,136	175,092	111,392
Noninterest income:				
Net gains from sale of loans and other mortgage production income	106,054	142,531	185,165	270,127
Mortgage loan origination fees	16,983	22,695	29,327	41,588
Net insurance premiums earned	40,777	38,590	81,096	76,063
Investment and securities advisory fees and commissions	22,264	25,964	43,599	47,973
Other	17,203	9,453	34,194	16,760
Total noninterest income	203,281	239,233	373,381	452,511
Noninterest expense:				
Employees compensation and benefits	124,445	132,715	230,874	248,905
Loss and loss adjustment expenses	35,275	48,160	53,612	69,345
Policy acquisition and other underwriting expenses	11,652	11,627	23,339	22,430
Occupancy and equipment, net	25,762	20,154	52,100	39,566
Other	54,078	47,744	103,916	95,145
Total noninterest expense	251,212	260,400	463,841	475,391
Income before income taxes	44,982	35,969	84,632	88,512
Income tax expense	16,294	13,309	30,648	32,479

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Net income	28,688	22,660	53,984	56,033
Less: Net income attributable to noncontrolling interest	177	568	287	868
Income attributable to Hilltop	28,511	22,092	53,697	55,165
Dividends on preferred stock	1,426	1,149	2,852	1,852
Income applicable to Hilltop common stockholders	\$ 27,085	\$ 20,943	\$ 50,845	\$ 53,313
Earnings per common share:				
Basic	\$ 0.30	\$ 0.25	\$ 0.56	\$ 0.64
Diluted	\$ 0.30	\$ 0.24	\$ 0.56	\$ 0.61
Weighted average share information:				
Basic	89,709	83,490	89,708	83,489
Diluted	90,569	90,294	90,576	90,125

See accompanying notes.

Table of Contents**HILLTOP HOLDINGS INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(in thousands)****(Unaudited)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	\$ 28,688	\$ 22,660	\$ 53,984	\$ 56,033
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale, net of tax of \$7,638, \$(15,249), \$17,221 and \$(14,776)	13,553	(28,320)	32,362	(27,441)
Comprehensive income (loss)	42,241	(5,660)	86,346	28,592
Less: comprehensive income attributable to noncontrolling interest	177	568	287	868
Comprehensive income (loss) applicable to Hilltop	\$ 42,064	\$ (6,228)	\$ 86,059	\$ 27,724

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	Accumulated	Accumulated	Total	Noncontrolling	Total
	Shares	Amount	Shares	Amount	Paid-in	Other	Deficit	Stockholders	Interest	Stockholders
					Capital	Income (Loss)		Equity		Equity
Balance, December 31, 2012	114	\$ 114,068	83,487	\$ 835	\$ 1,304,448	\$ 8,094	\$ (282,949)	\$ 1,144,496	\$ 2,054	\$ 1,146,550
Net income							55,165	55,165	868	56,033
Other comprehensive loss						(27,441)		(27,441)		(27,441)
Stock-based compensation expense					480			480		480
Common stock issued to board members			4		47			47		47
Issuance of restricted common stock			465	5	(5)					
Dividends on preferred stock					(1,852)			(1,852)		(1,852)
Cash distributions to noncontrolling interest									(2,017)	(2,017)
Balance, June 30, 2013	114	\$ 114,068	83,956	\$ 840	\$ 1,303,118	\$ (19,347)	\$ (227,784)	\$ 1,170,895	\$ 905	\$ 1,171,800
Balance, December 31, 2013	114	\$ 114,068	90,176	\$ 902	\$ 1,388,641	\$ (34,863)	\$ (157,607)	\$ 1,311,141	\$ 781	\$ 1,311,922
Net income							53,697	53,697	287	53,984
Other comprehensive income						32,362		32,362		32,362
Stock-based compensation expense					1,979			1,979		1,979
Common stock issued to board members			5		115			115		115
Dividends on preferred stock					(2,852)			(2,852)		(2,852)
Cash distributions to noncontrolling interest									(348)	(348)
Balance, June 30, 2014	114	\$ 114,068	90,181	\$ 902	\$ 1,387,883	\$ (2,501)	\$ (103,910)	\$ 1,396,442	\$ 720	\$ 1,397,162

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended June 30,	
	2014	2013
Operating Activities		
Net income	\$ 53,984	\$ 56,033
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	8,775	24,294
Depreciation, amortization and accretion, net	(48,612)	(18,032)
Deferred income taxes	4,842	(11,528)
Other, net	2,191	533
Net change in securities purchased under resale agreements		(3,237)
Net change in trading securities	(2,817)	57,256
Net change in broker-dealer and clearing organization receivables	(146,643)	(76,430)
Net change in other assets	(28,818)	34,972
Net change in broker-dealer and clearing organization payables	177,748	17,281
Net change in loss and loss adjustment expense reserve	7,678	8,446
Net change in unearned insurance premiums	6,189	7,813
Net change in other liabilities	4,645	(37,247)
Net gains from sale of loans	(185,165)	(270,127)
Loans originated for sale	(4,927,983)	(6,545,177)
Proceeds from loans sold	4,782,239	6,769,795
Net cash provided by (used in) operating activities	(291,747)	14,645
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	911	
Proceeds from sales, maturities and principal reductions of securities available for sale	97,867	96,069
Purchases of securities held to maturity	(66,207)	
Purchases of securities available for sale	(47,557)	(223,570)
Net change in loans	68,552	(51,027)
Purchases of premises and equipment and other assets	(19,815)	(11,417)
Proceeds from sales of premises and equipment and other real estate owned	38,281	4,859
Net cash paid for Federal Home Loan Bank and Federal Reserve Bank stock	(31,440)	(21,219)
Net cash provided by (used in) investing activities	40,592	(206,305)
Financing Activities		
Net change in deposits	(647,143)	(179,826)
Net change in short-term borrowings	845,106	275,554
Proceeds from notes payable	1,000	
Payments on notes payable	(1,743)	(1,601)
Dividends paid on preferred stock	(2,768)	(703)
Net cash distributed to noncontrolling interest	(348)	(2,017)
Other, net	(187)	(154)
Net cash provided by financing activities	193,917	91,253
Net change in cash and cash equivalents	(57,238)	(100,407)
Cash and cash equivalents, beginning of period	746,023	726,460

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Cash and cash equivalents, end of period	\$	688,785	\$	626,053
Supplemental Disclosures of Cash Flow Information				
Cash paid for interest	\$	13,046	\$	14,889
Cash paid for income taxes, net of refunds	\$	5,582	\$	40,949
Supplemental Schedule of Non-Cash Activities				
Conversion of loans to other real estate owned	\$	34,391	\$	1,718

See accompanying notes.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

1. Summary of Significant Accounting and Reporting Policies

Nature of Operations

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

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

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

On March 31, 2014, the Company entered into a definitive merger agreement with SWS Group, Inc. (SWS) providing for the merger of SWS with and into Peruna LLC, a wholly owned subsidiary of Hilltop formed for the purpose of facilitating this transaction. SWS stockholders will receive per share consideration of 0.2496 shares of Hilltop common stock and \$1.94 of cash, equating to \$7.25 per share based on Hilltop s closing price on June 30, 2014. The value of the merger consideration will fluctuate with the market price of Hilltop common stock. The Company intends to fund the cash portion of the consideration through available cash. The merger is subject to customary closing conditions, including regulatory approvals and approval of the stockholders of SWS, and is expected to be completed prior to the end of 2014.

Basis of Presentation

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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 amounts receivable under the loss-share agreements with the FDIC (FDIC Indemnification Asset), reserves for losses and loss adjustment expenses, the mortgage loan indemnification liability, and the potential impairment of assets are particularly subject to change. The Company has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.

Certain reclassifications have been made to the prior period consolidated financial statements to conform with the current period presentation.

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), PCB-ARC, Inc. and RGV-ARC, Inc. The Bank has a 100% membership interest in First Southwest Holdings, LLC (First Southwest) and PlainsCapital Securities, LLC.

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

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

The principal subsidiaries of First Southwest are First Southwest Company (FSC), a broker-dealer registered with the SEC and the Financial Industry Regulatory Authority and a member of the New York Stock Exchange, 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).

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

2. Acquisitions

FNB Transaction

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

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.

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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 fair values as of the Bank Closing Date using significant estimates and assumptions to value certain identifiable assets acquired and liabilities assumed. The amounts are subject to adjustments based upon final settlement with the FDIC. The terms of the P&A Agreement provide for the FDIC to indemnify the Bank against claims with respect to liabilities and assets of FNB or any of its affiliates not assumed or otherwise purchased by the Bank and with respect to certain other claims by third parties.

Pro Forma Results of Operations

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

3. Fair Value Measurements

Fair Value Measurements and Disclosures

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

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

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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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Fair Value Option

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

At June 30, 2014, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.41 billion, and the unpaid principal balance of those loans was \$1.35 billion. At December 31, 2013, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.09 billion, and the unpaid principal balance of those loans was \$1.07 billion. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

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

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

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
June 30, 2014				
Trading securities	\$ 35	\$ 61,628	\$	\$ 61,663
Available for sale securities	24,653	1,113,306	63,819	1,201,778
Loans held for sale		1,400,464	10,409	1,410,873
Derivative assets		35,454		35,454
Mortgage servicing rights asset			35,877	35,877
Trading liabilities		48		48
Derivative liabilities		13,847	6,300	20,147

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
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December 31, 2013

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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Balance at Beginning of Period	Purchases/ Additions	Sales/ Reductions	Total Gains or Losses (Realized or Unrealized) Included in Net Income	Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended						
June 30, 2014						
Available for sale securities	\$ 64,098	\$	\$	\$ 616	\$ (895)	\$ 63,819
Loans held for sale	26,826	5,522	(24,009)	2,070		10,409
Mortgage servicing rights asset	29,939	7,376		(1,438)		35,877
Derivative liabilities	(5,950)			(350)		(6,300)
Total	\$ 114,913	\$ 12,898	\$ (24,009)	\$ 898	\$ (895)	\$ 103,805
Six months ended June 30,						
2014						
Available for sale securities	\$ 60,053	\$	\$	\$ 1,209	\$ 2,557	\$ 63,819
Loans held for sale	27,729	10,422	(29,603)	1,861		10,409
Mortgage servicing rights asset	20,149	14,808		920		35,877
Derivative liabilities	(5,600)			(700)		(6,300)
Total	\$ 102,331	\$ 25,230	\$ (29,603)	\$ 3,290	\$ 2,557	\$ 103,805
Three months ended						
June 30, 2013						
Available for sale securities	\$ 58,801	\$	\$	\$ 531	\$ (3,822)	\$ 55,510
Mortgage servicing rights asset	4,430	2,180		501		7,111
Derivative liabilities	(4,714)			(225)		(4,939)
Total	\$ 58,517	\$ 2,180	\$	\$ 807	\$ (3,822)	\$ 57,682
Six months ended June 30,						
2013						
Available for sale securities	\$ 56,277	\$	\$	\$ 1,043	\$ (1,810)	\$ 55,510
Mortgage servicing rights asset	2,080	4,305		726		7,111
Derivative liabilities	(4,490)			(449)		(4,939)
Total	\$ 53,867	\$ 4,305	\$	\$ 1,320	\$ (1,810)	\$ 57,682

All net realized and unrealized gains (losses) in the tables above are reflected in the accompanying consolidated financial statements. The unrealized gains (losses) relate to financial instruments still held at June 30, 2014. The available for sale securities noted in the table above reflect Hilltop's note receivable and warrant to purchase common stock of SWS as discussed in Note 4 to the consolidated financial statements.

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For Level 3 financial instruments measured at fair value on a recurring basis at June 30, 2014, the significant unobservable inputs used in the fair value measurements were as follows.

Financial instrument	Valuation Technique	Unobservable Input	Weighted Average / Range
Available for sale securities - note receivable	Discounted cash flow	Discount rate	8.3%
Available for sale securities - warrant	Binomial model	SWS common stock price volatility	24.0%
Loans held for sale	Discounted cash flow / Market comparable	Projected price	86 - 90%
Mortgage servicing rights asset	Discounted cash flow	Constant prepayment rate Discount rate	10.32% 11.11%
Derivative liabilities	Discounted cash flow	Discount rate Time to receive full payment of cash flows	14 - 28% 10.75 - 14.0 years

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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 fair value of certain loans held for sale that are either non-standard (i.e. loans that cannot be sold through normal sale channels) or non-performing is measured using unobservable inputs. The fair value of such loans is generally based upon estimates of expected cash flows using unobservable inputs including listing prices of comparable assets, uncorroborated expert opinions, and/or management's knowledge of underlying collateral.

The MSR asset is valued by projecting net servicing cash flows, which are then discounted to estimate the fair value. The fair value of the MSR asset is impacted by a variety of factors. Prepayment rates and discount rates, the most significant unobservable inputs, are discussed further in Note 7 to the consolidated financial statements.

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

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

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

	Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option Three Months Ended June 30, 2014			Three Months Ended June 30, 2013		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	\$ 35,651	\$	\$ 35,651	\$ (36,203)	\$	\$ (36,203)
Mortgage servicing rights asset	(1,438)		(1,438)	501		501
Time deposits					4	4