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 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, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 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, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 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 Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Hilltop Stockholders Equity	Noncontrolling Interest	Total Stockholders Equity
Balance, December 31, 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

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.

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.

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**	**Total**	**Accruing Loans Past Due**